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April 19, 2017

The Honorable Michael Crapo, Chairman
The Honorable Sherrod Brown, Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington DC 20510

Dear Chairman Crapo and Ranking Member Brown,

We are very pleased to respond to your solicitation of economic growth proposals for consideration by your committee. Your focus on growth is well-placed and highly commendable. We firmly believe that with the right public policies across all areas—tax reform, health policy, open trade measures, regulatory reform, among others--lawmakers can help increase America's economic expansion rate as much as two percentage points above our current anemic level. That higher growth rate would mean a better life for millions of our citizens, as new jobs are created and personal incomes rise.

An essential requirement for future economic growth is a strong and sound financial system. Sustained growth can only occur if the financial markets have confidence in the stability of the financial system. We recognize the positive policy changes that have occurred since the crisis. The bipartisan move towards central clearing of most derivatives contacts, for example, has enhanced transparency, increased the margin of safety, and added stability to a massive and important market. Nevertheless, much more policy work needs to be done to avoid a repeat of the 2008 disaster and allow rapid economic expansion.

We hope our perspective will be useful. Our firm, Elliott Management Corporation, just celebrated its 40th anniversary, which makes us the oldest firm of its type under continuous management. Over the decades, we have faced a wide variety of market conditions, ranging from equity market bust of 1973-74 to the inflationary boom of the late 1970s and the recessions that followed, to the years of growth and low inflation in the 1980s and 90s, the dotcom boom and bust, and of course the Global Financial Crisis of 2008. Although our firm is not directly affected by many of the policy changes you will consider, our role as long time market participants gives us a strong (and unconflicted) sense of the impact of public policy on economic growth. We see day-to-day how important it is to preserve rules-based certainty in the marketplace, and we know how poor government policy undermines that certainty and retard economic growth.

Our economic growth recommendations in the area of financial policy are as follows:

Strengthen Treatment of Non-Cleared Derivatives

As we watched the 2008 crisis unfold, we saw that it was largely driven by the massive liabilities, losses and uncertainties created by opaque and inadequately margined derivatives held by overleveraged financial institutions. As the committee knows, large financial institutions had not posted initial margin when directly facing each other in derivatives trades, which is a key reason they were able to build such vast positions in the run-up to the crisis. This situation has still not been sufficiently addressed. Moreover, there are exceptions to the applicability of even the rules that exist (for "end-users" and government debt securities), and the rules do apply globally. In addition, there are still very large positions which are not even subject to variation margin (thus allowing in an environment of market turmoil the rapid buildup of very large unsecured debit balances).

We strongly recommend that policy makers require that every counterparty (regardless of rating or legal form, including sovereigns) post the same initial margin on every bilateral contact that the biggest banks now charge to customers, and every counterparty should be subject to full two-way daily mark-to-market variation margin payments and receipts. No exceptions for rating or status of counterparty should be made. Otherwise, unbalanced and unsecured risks can build in pockets where regulation is most lax. This fix alone, had it been in place in 2008, would have prevented the crisis by providing a significant capital cushion against the unexpected price movements in that highly volatile period, and by limiting the number of poorly understood derivatives that bloated the world's largest institutions. No customer who posted initial margins on all its derivatives positions posed a systemic risk in 2008.

Modify Cross Default Clauses in Derivative Contracts

We were the largest creditor of the Lehman estate and were in a position to closely observe what worked—and didn't work—in its resolution. Our view is that, contrary to common belief, the Bankruptcy Code would have been largely adequate to deal with the collapse, but for one major problem: The cross default provisions common to bilateral derivatives contracts. These provisions meant that when the Lehman parent filed for bankruptcy, Lehman's derivatives counterparties had the legal right to terminate their derivatives contracts with Lehman subsidiaries—even though the subsidiaries themselves had up to that point made all the necessary margin payments. The termination rules in the derivatives contracts allowed the counterparties to seize collateral and pursue one-sided remedies that quickly created a massive hole of tens of billions of dollars at Lehman as well as creating massively unsettled derivative markets around the world. The possibility of contract terminations in bilateral derivatives due to cross defaults should be eliminated so that derivatives books which are properly managed can avoid termination so long as variation margin continues to be paid. Dodd-Frank and certain legislative proposals have attempted to address this issue by placing a brief stay on termination rights, but the brevity only encourages more financial manipulation by compelling regulators or debtors to move these contracts into newly formed bridge companies which would create

additional uncertainty for creditors. And efforts to limit cross defaults by compelling contract holders to adhere to the resolution authorities created post-crisis are an insufficient substitute, especially because of the infirmities of these authorities in effectively dealing with a future derivatives crisis.

Repeal Dodd-Frank's Orderly Liquidation Authority

As a financially healthy creditor firm, we have a strong sense of how market participants react to uncertainty. For this reason, we continue to be deeply alarmed at the profound uncertainty created by Dodd-Frank's Orderly Liquidation Authority. OLA would allow government officials to seize massive financial institutions on a purely subjective judgement that they are "in danger of default." Post-seizure, officials would have wide latitude to establish bridge companies, shift assets to them with little due process, and then treat creditors differently even if they hold the same priority of claims. This broad official discretion undermines the ability of investors to confidently assess how their claims will be handled in a distressed situation. As long as it remains on the books, there is a serious threat that creditors will be spurred to sell their debt instruments as soon as there is any indication (or even a rumor) that an institution is troubled. In a full-fledged financial crisis, this elimination of due process and respect for legal priorities and rights would be an extreme accelerant. Dodd-Frank's OLA should be repealed.

Address Market Distortions Caused By SIFI Designation

Designating some institutions as Systemically Important Financial Institutions strongly reinforces the markets' perception that they are too-big-to-fail and would receive public support in distress. This creates serious distortions in financial markets, which is costly and inefficient in normal times and will be highly dangerous when the next crisis hits. By illustration, when a non-SIFI creditor directly competes with a SIFI creditor, the SIFI has an inherent advantage due to the market expectation that the SIFI is more likely to receive preferred treatment in a future crisis. This unfair playing field impairs healthy competition for the allocation of capital and tends to make SIFIs larger, impelling further risky consolidation of the financial industry. And attempts to counterbalance the benefits of SIFI status through additional regulation only create more distortions that impede the efficient flow of capital.

The SIFI designation may also serve as an accelerant in the next crisis. In a time of financial stress, a small non-SIFI creditor of a large financial institution will expect to get worse treatment than a SIFI creditor who holds a similar claim against the large institution (a particular concern since Dodd-Frank allows disparate treatment of similarly situated creditors). The non-SIFI creditor will have a powerful incentive to pre-emptively pull its money out of the large institution, perversely making default more likely. Designating certain firms as SIFIs is a poor substitute for system-wide policies that can actually make financial institutions safer and sounder, such as maintaining higher levels of capital and clear, predictable rules of the road. Our recommendation: Eliminate the federal authority to designate SIFIs.

Explore Ways to Increase Transparency of Derivatives Books

There's an ignored aspect of our financial system that urgently demands attention: The largest investment banks still, almost ten years after the financial crisis, each hold tens of trillions of dollars in notional amounts of derivatives whose characteristics are not publicly disclosed in a meaningful way. The existing public disclosure requirements for these positions are utterly insufficient. The market cannot understand the risks embedded in the books of these institutions, and massive time bombs may lurk. The banks claim that "netting agreements" reduce the possibility of losses to negligible amounts, but as practitioners we assure you that massive potential losses lurk in these books in the next period of serious market turmoil. In 2008, even the banks themselves did not understand the risks inherent in their own derivatives positions, much less those of their counterparties to multi-billion dollar contracts. The opacity of the banks' derivatives books will be an accelerant of a future crisis because the market will rely on rumor, instead of analysis of (unavailable) facts, when considering the solvency of a large financial institution's risk positions which, in turn, impacts the solvency of both the institution itself and its counterparties. Moreover, in a crisis the speed of price changes will prevent executives and policymakers from having any accurate understanding of the losses that could be building from massive derivatives positions in a matter of minutes. Policymakers should require more frequent and far more robust reporting of derivatives positions held by publicly traded institutions, and to the extent possible, the U.S. should harmonize these (along with margin requirements) with our G-20 partners. Having an intelligent set of financial system soundness policies without such harmonization risks a "race to the bottom." At a minimum, the committee should hold hearings and closely examine these neglected issues.

Enhance Shareholder Activism

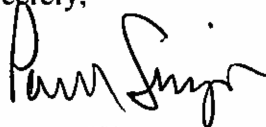
Active engagement by shareholders is one of the great sources of America's economic dynamism. It is a free market way of holding the managements of our public corporations accountable, and ensuring that they will work for the benefit of all shareholders. Activism helps reduce management compensation abuses, conflicts of interest, and cronyism. It improves corporate governance. If a corporate board is filled with individuals who are successful in their own right but have little actual experience in the business or industry of the company, activists push for directors possessing the necessary skills and experience. Activism directly spurs innovation and growth by encouraging corporations to pursue the most effective business strategies and the optimal capital structure. The results are clear. A *Bloomberg* study in 2014 found that stocks of companies focused on by activist investors from 2009 to 2013 rose by an average of 48%--which was 17% higher than the rise in S&P index in the same period. All shareholders benefit from this activity—including institutional investors such as pension funds, charities, and educational endowments.

Unfortunately, in the years since Congress enacted the Williams Act and attempted to set a proper balance between the rights of shareholders and corporate management, entrenched managers have developed a variety of techniques to avoid being held accountable by shareholders. From "poison pill" contracts, to staggered board elections, to lobbying for state protection laws, they have found ways to frustrate Congress' desire for balance.

If the committee sees fit to revisit the Williams Act and other laws affecting shareholder activism, we recommend it consider restoring the balance by enhancing beneficial shareholder activism. Specifically, the 5% disclosure threshold in 13D should be increased to a level appropriate for modern realities. The committee might also consider revising Hart-Scott-Rodino rules to allow necessary information to be shared with the government on a confidential basis.

We would be happy to elaborate on these ideas or help the committee in other ways. We very much appreciate your willingness to consider these and other economic growth proposals.

Sincerely,



Paul E. Singer