REBALANCING THE FINANCIAL REGULATORY LANDSCAPE

MAY 1, 2017

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Executive Summary

Core Principles for Regulating the United States Financial System

(a) Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;

(b) Prevent taxpayer-funded bailouts;

(c) Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;

(d) Enable American companies to be competitive with foreign firms in domestic and foreign markets;

(e) Advance American interests in international financial regulatory negotiations and meetings;

(f) Make regulation efficient, effective, and appropriately tailored; and

(g) Restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.

The Treasury Secretary's report on which financial laws and regulations promote and support President Trump's Core Principles is an important opportunity to take stock of and reframe the policy discussions around post-financial crisis regulation. SIFMA strongly supports the Core Principles as the right framework for rebalancing U.S. financial regulation. This White Paper covers key topic areas where the SIFMA membership has gathered together those recommendations that it believes, if adopted, would rebalance financial laws, regulations and guidance in a way that will allow the financial sector to promote job creation and economic growth while maintaining a robust regulatory regime and preserving financial stability.

Each topic in this White Paper is covered in a separate Chapter and includes: regulatory architecture and good governance, stress testing and capital requirements, liquidity and funding requirements, the Volcker Rule, living wills, derivatives, incentive compensation, key topics in banking regulation, securitization, promoting equity market issuances, enhanced prudential standards for foreign banking organizations, and fiduciary regulation.

Each Chapter in the White Paper describes the original reason for the policy, sets forth the need for rebalancing and explains SIFMA's recommendations and the reasons behind them in detail. A short-form grid of the recommendations is set forth at the end of this Executive Summary.[1]

The Executive Summary begins by situating the recommendations and the need for rebalancing within the context of the increased resiliency of the U.S. financial system today, the need to maintain those regulatory enhancements that are key to financial stability and in light of the slow economic recovery after the financial crisis.

A. Today's Financial Sector is Resilient

Post-financial crisis regulatory and supervisory reform, driven by the Dodd-Frank Act, was a paradigm shift in U.S. financial regulation, significantly

[1] At the end of the White Paper, Appendices provide a glossary and an annotated bibliography, by topic, of both primary and secondary sources, including the statute, regulations and past comments, studies and reports.

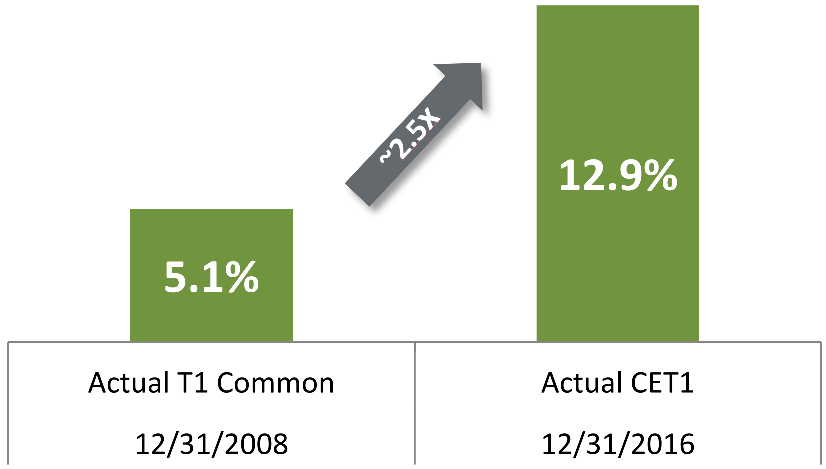
> "Less than a decade after being the epicenter of a global financial crisis, today the United States has the strongest and most diverse financial system of any major economy in the world….[T]he regulatory reform program put in motion even before the crisis had ended….has steadily strengthened the capital, liquidity, and risk management positions of large banks, with progressively more stringent measures applied to the most systemically important institutions."[2]
>
> *– Daniel K. Tarullo, Governor, Federal Reserve*

expanding the number, breadth and intensity of regulatory and supervisory requirements to which the U.S. financial sector is subject. Many of the policies required by the Dodd-Frank Act or promoted in the aftermath of the financial crisis have made the U.S. financial system stronger and more resilient today than it was in 2008. These changes have significantly reduced the probability that a major banking organization would fail during an extreme market shock, while also reducing the potential cost if such a failure were to occur. In particular, U.S. banking organizations have more and higher quality capital, which provides them a larger buffer against failure if they experience unexpected losses. They also depend less on runnable funding and have increased their holdings of liquid assets to help them endure short-term market distress.

The largest and most complex banking organizations:

- Have more than two times the Common Equity Tier 1 capital as a percentage of risk-weighted assets compared to 2008;

Figure 1

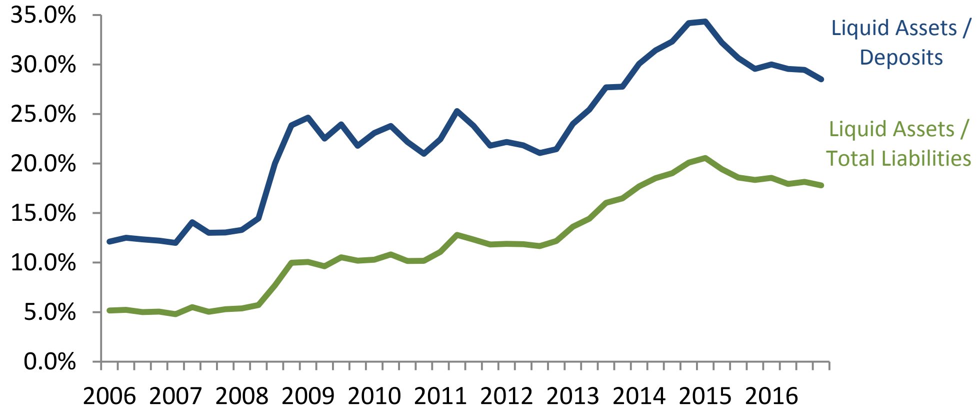


Source: Prepared by Davis Polk & Wardwell LLP. See Appendix B for more detail.

- Have more than three times more liquid assets as a percentage of deposits and as a percentage of total liabilities compared to before the financial crisis;

[2] Daniel K. Tarullo, Governor, Fed. Reserve, Financial Regulation Since the Crisis (Dec. 2, 2016) (link).

Figure 2

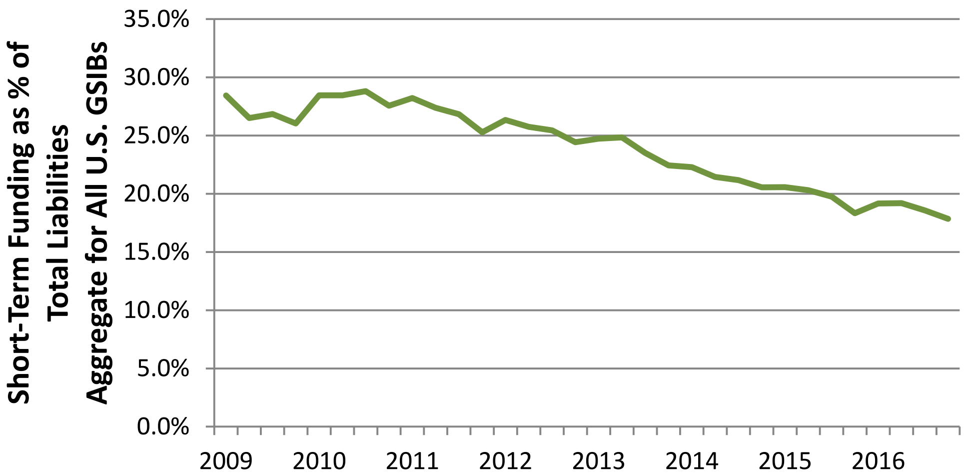


Source: Prepared by Davis Polk & Wardwell LLP. See Appendix B for more detail.

- Have substantially decreased their reliance on short-term wholesale funding and have lengthened the duration of any remaining short-term wholesale funding; and

> "Since the crisis, the Federal Reserve has taken several steps to address short-term wholesale funding risks….In part because of these actions and part because of market adjustments, there is less risk embedded in short-term wholesale funding markets today than in the period immediately preceding the financial crisis. The short-term wholesale funding markets are generally smaller, the average maturity of short-term funding arrangements is moderately greater, and collateral haircuts are more conservative."[3]
>
> *– Daniel K. Tarullo, Governor, Federal Reserve*

Figure 3



Source: Prepared by Davis Polk & Wardwell LLP. See Appendix B for more detail.

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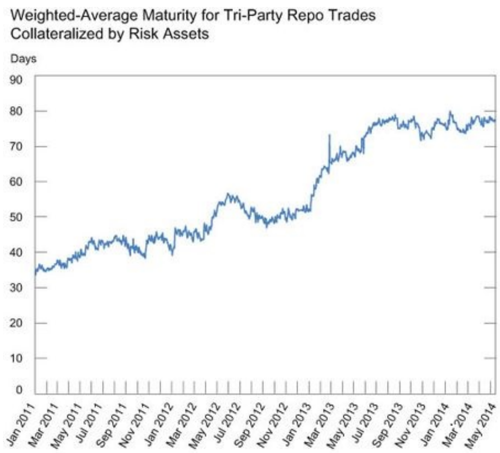
[3] Daniel K. Tarullo, Governor, Fed. Reserve, Dodd-Frank Implementation (Sept. 2, 2014) (link).

Figure 4



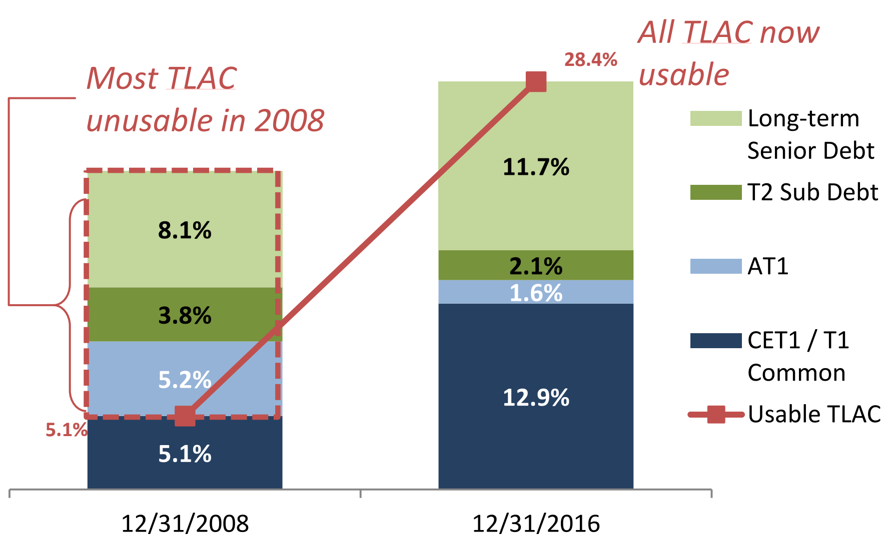
Source: Federal Reserve Bank of New York. Data past May 2014 not available. See Appendix B for more detail.

> "There has been a transformational change in the United States and internationally since the financial crisis in regard to the resolution of systemically important financial institutions that perhaps has been underappreciated."[4]
>
> – *Martin Gruenberg, Chair, FDIC*

- Have five times as much properly structured usable total loss-absorbing capacity, or TLAC, which consists of equity and long-term debt that, in the event that significant buffers against failure were inadequate, could be used to absorb the top-tier parent's losses and recapitalize its material subsidiaries without the need for taxpayer-funded bailouts and helping to prevent contagion throughout the financial system.

Figure 5

In 2008, long-term senior debt was not usable without imposing losses *pro rata* on short-term senior debt such as commercial paper, provoking runs in short-term wholesale funding markets, and subordinated debt and additional Tier 1 capital were considered unusable because of market confusion about the loss waterfall.



Source: Prepared by Davis Polk & Wardwell LLP. See Appendix B for more detail.

[4] Martin J. Gruenberg, Chair, FDIC, Remarks to the FDIC Banking Research Conference (Sept. 17, 2015) (link).

Trading in OTC derivatives markets has become much safer through enhanced transparency, mandatory central clearing for standardized OTC derivatives, margin requirements for non-cleared derivatives and registration and regulation of key market participants. All CFTC-regulated swaps, amounting to over 95% of the notional value of the OTC derivatives markets, are now reported to trade repositories if a U.S. person or non-U.S. affiliate swap dealer is a party to the trade. The majority of the notional volume of interest rate swaps and index credit default swaps are centrally cleared and traded on CFTC-registered SEFs. By September 1, 2017, new non-cleared swaps between financial entities will be secured by daily mark-to-market margin, preventing the buildup of unsecured exposure over time and thereby significantly mitigating systemic risk.

Since the financial crisis, the cumulative effect of stress testing, higher capital and liquidity, resolution and recovery planning, the regulation of OTC derivatives markets and various other reforms has led to the financial system becoming significantly more resilient and stable.

B. Regulatory Enhancements that Support Financial Stability Should Be Maintained

SIFMA strongly believes in a well-regulated financial sector. Many regulations that affect the financial sector are essential to ensure the safety and soundness of the financial system and individual financial institutions, and to protect depositors, investors and consumers. The experience of the financial crisis shows that the following key elements are the core base of a sound regulatory framework for a stable financial system. SIFMA's recommendations would preserve these elements, many of which have been enhanced since the financial crisis:

- Enhanced risk-based capital standards that emphasize reliance on common equity and well in excess of required and actual capital before the financial crisis;
- Enhanced risk-insensitive leverage-based capital requirements as a backstop measure to ensure capital adequacy;
- Supervised stress-testing;

- Enhanced liquidity requirements, providing banking organizations with substantial buffers to withstand acute shocks;
- A large quantity of properly structured TLAC that could be used to impose losses on private sector shareholders and long-term bondholders and shield taxpayers and the holders of runnable short-term liabilities in the event of the failure of a G-SIB;
- Strategic, detailed and actionable plans for how to resolve systemically important firms;
- Appropriate margining and clearing of OTC derivatives;
- A vast array of activity restrictions on regulated firms; and
- Safety and soundness regulation for prudentially supervised firms.

SIFMA strongly believes that the financial sector would continue to be well-regulated even after rebalancing the financial regulatory system to take into account the recommendations.

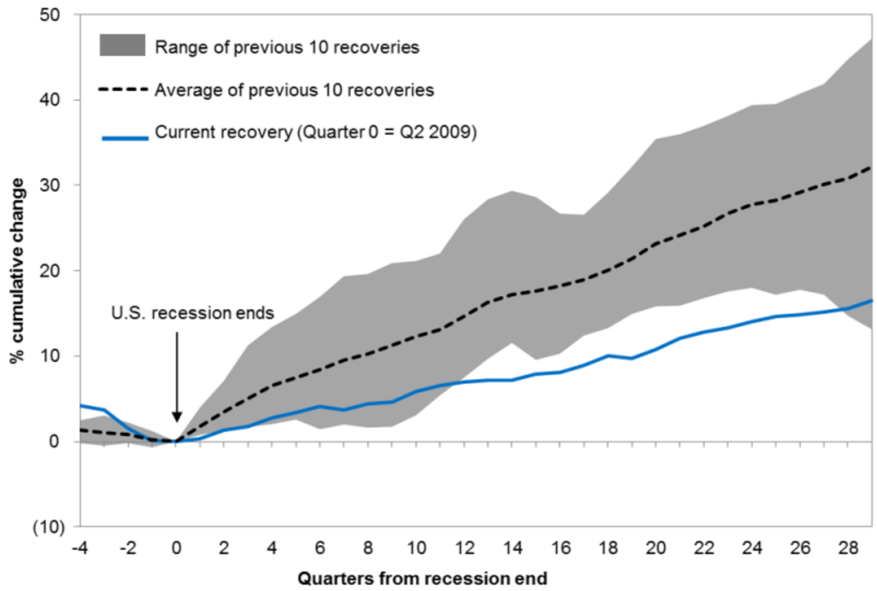
SIFMA also believes that these key elements eliminate the need for any new structural reforms beyond the activities restrictions already imposed on insured banks under Section 16 of the Glass-Steagall Act, which remains in full force and effect, and the limits on transactions between insured banks and their nonbank affiliates under Sections 23A and 23B of the Federal Reserve Act. More radical structural limits, such as the mandatory separation of commercial banking from investment banking, are unnecessary in light of the existing prudential safeguards and structural limits, and would impose undue costs on bank customers and markets, and significantly constrain economic growth.

C. There Has Been Too Slow a Recovery After the Crisis

> "Although job growth has been strong, gross domestic product has increased only about 2 percent annually since the crisis, held down by the weakest sustained period of labor productivity since World War II. Labor productivity—the increase in output per hour—has increased only 1/2 percent per year since 2011, about a quarter of its post-war average. The productivity slowdown has profound implications for our national well-being….We need a national focus on increasing the sustainable growth rate of our economy"[5]
>
> *– Jerome H. Powell, Governor, Federal Reserve*

It must be acknowledged that the U.S. economy has experienced the slowest economic recovery of the post-war period.[6] Real gross domestic product stands at only 111% of the 2007 level,[7] and the economy has been stuck in slow gear.[8]

Figure 6



Source: Bureau of Economic Analysis and Goldman Sachs Global Investment Research. See Appendix B for more detail.

The U.S. banking agencies, and in many cases the Federal Reserve, acting on its own, could make a difference quite quickly with a moderate rebalancing of capital, liquidity and stress testing regimes. If banking organizations were allowed to free up more of their capital and liquidity, there could be more lending to consumers and businesses to finance expansion. At the moment, however, the post-crisis liquidity rules require banks to hold approximately $2 trillion in cash and other liquid assets

[5] Jerome H. Powell, Governor, Fed. Reserve, Brief Remarks (Apr. 20, 2017) (link).

[6] Eric Morath, *Seven Years Later, Recovery Remains the Weakest of the Post-World War II Era*, WALL ST. J. (Jul. 29, 2016) (link).

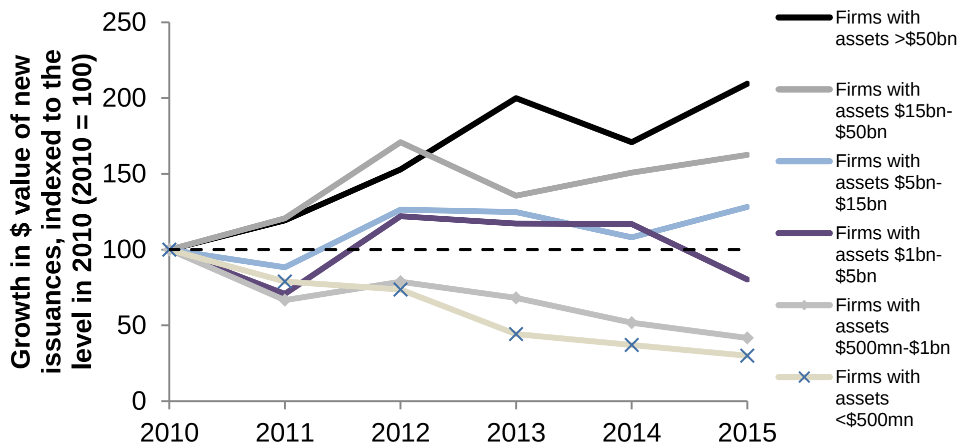
[7] Dennis Lockhart, President and CEO, Fed. Reserve Bank of Atlanta, Crisis, Recession, and Recovery: 2007–16 (Jan. 9, 2017) (link).

[8] Janet L. Yellen, Chair, Fed. Reserve, Macroeconomic Research After the Crisis (Oct. 14, 2016) (link).

> "Getting a mortgage remains especially tough for first-timers. Since the bust, an estimated 6 million or so fewer loans have been made because of lenders' extraordinary reticence to extend credit. This has not been a matter of restoring sound underwriting. Instead, it is a response to the rise in regulatory and legal risks associated with originating and servicing loans that fail."[14]
>
> *– Mark Zandi, Chief Economist, Moody's Analytics*

deposited at the Federal Reserve,[9] regardless of whether there is additional lending demand from highly creditworthy borrowers, and tighter bank lending standards required as a result of the Dodd-Frank Act have slowed growth in lending supply even if liquidity was not being trapped on bank balance sheets. Private credit extended to households and nonfinancial businesses has grown at a slower pace than in all recoveries in the past 60 years.[10] Small businesses, in particular, have found it difficult to obtain credit.[11] Another key factor is lending costs and frictions in the mortgage market, potentially reducing new purchase volume by $500 billion a year.[12] The relative capital intensity of securitization means that less credit supported by securitization is provided, and other forms of financing are not replacing securitizations.[13]

Figure 7



Source: Goldman Sachs Global Investment Research. See Appendix B for more detail.

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[9] Liz Capo McCormick & Daniel Kruger, *U.S. Banks Hoard $2 Trillion of Ultra-Safe Bonds*, BLOOMBERG (Feb. 22, 2015) (link).

[10] Zheng Liu & Andrew Tai, *Slow Credit Recovery and Excess Returns on Capital* (Fed. Reserve Bank of San Francisco Economic Letter 2016-28, Sept. 26, 2016) (link).

[11] FED. RESERVE BANKS OF ATLANTA, BOSTON, CHICAGO, CLEVELAND, DALLAS, KANSAS CITY, MINNEAPOLIS, NEW YORK, PHILADELPHIA, RICHMOND, ST. LOUIS & SAN FRANCISCO, SMALL BUSINESS CREDIT SURVEY (Apr. 2017) (link).

[12] J.P. Morgan, The cost of post-crisis regulation on mortgage lending (Mar. 31, 2017).

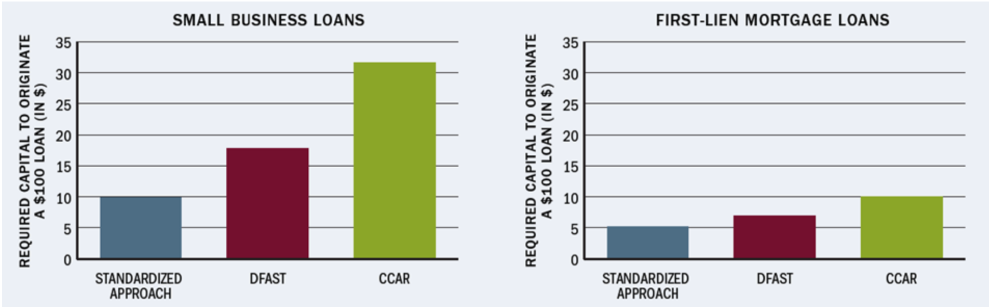
[13] Faten Sabry & Chudozie Okongwu, *Study of the Impact of Securitization on Consumers, Investors, Financial Institutions, and the Capital Markets* (American Securitization Forum Report, June 17, 2009) (link).

[14] Mark Zandi, *How the Trump Administration Can Continue Progress in U.S. Housing*, WASHINGTON POST (Jan. 5, 2017) (link).

> "[Regional banks] do what they do best by making lending decisions based … on their wealth of local knowledge and experience ... but … have been forced … to deploy a cold and calculated rubric that fails to comprehensively evaluate the ineffable quality of loans they make to small businesses."[15]
>
> *– Roger G. Wilmers, Chair of the Board and CEO, M&T Bank*

Additionally, the Federal Reserve's CCAR stress test imposes dramatically higher *de facto* capital requirements on certain asset classes, notably small business loans and residential mortgages, than would otherwise be prescribed by the capital rules. CCAR's weighting of these asset classes encourages reallocation of capital away from the borrowers that need it most. Small businesses account for more than 40 percent of private nonfarm GDP, and choking off credit to these firms causes significant damage to our prospects for economic growth and job creation.[16]

Figure 8



Source: The Clearing House. See Appendix B for more detail.

Fewer firms are going public. U.S. financial markets provide a critical source of financing for businesses. There were an average of 282 IPOs per year from 1976 to 2000, and since then there have been an average of 114 per year.[17] Dollars raised has similarly declined, and IPO volume has declined despite rising valuations.[18] While IPOs and mergers and acquisitions activity typically exhibit a high degree of correlation, ticking upwards in response to strong equity markets, recent data shows a divergence, with increased mergers and acquisitions activity in the face of a declining IPO market.[19]

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[15] Roger G. Wilmers, Chair of the Board and CEO, M&T Bank, 2016 Annual Report Message to Shareholders (Mar. 9, 2017) (link).

[16] THE CLEARING HOUSE, THE CAPITAL ALLOCATION INHERENT IN THE FEDERAL RESERVE'S CAPITAL STRESS TEST (Jan. 2017) (link).

[17] CREDIT SUISSE GLOBAL FINANCIAL STRATEGIES, THE INCREDIBLE SHRINKING UNIVERSE OF STOCKS (Mar. 22, 2017) (link).

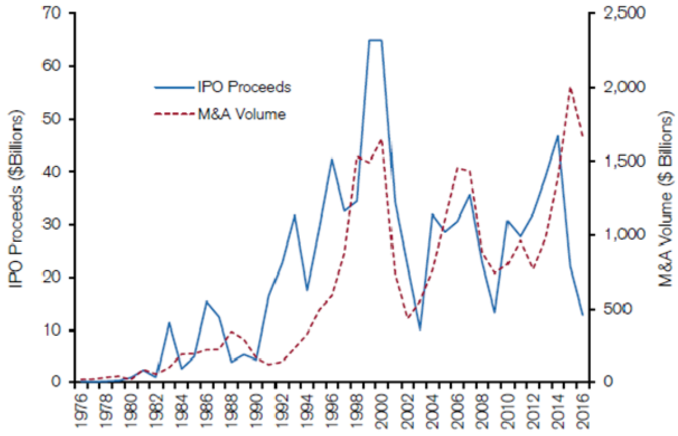
[18] See charts in Chapter 10.

[19] CREDIT SUISSE GLOBAL FINANCIAL STRATEGIES, THE INCREDIBLE SHRINKING UNIVERSE OF STOCKS (Mar. 22, 2017) (link).

> "Because it is difficult to raise capital, small firms increasingly are finding it difficult to compete with larger firms. Instead, they are selling themselves to their larger competitors. Much of the increased corporate bond issuance is from large firms financing the acquisitions of small firms—the highest share in 15 years. As a result, the likely risk to the economy is less job creation, less competition, less research and development and capex—less dynamism overall."[20]
>
> *– Ronald J. Kruszewski, Chair and CEO of Stifel*

> "Regulatory authorities made a mistake when they looked at each institution and they said you'll be safer if you withdraw from the markets a bit, and then forgot that if all institutions withdraw from the markets a bit, the markets will be less liquid. The markets themselves will be less safe, and that will in the end hurt all the institutions."[21]
>
> *– Lawrence H. Summers, Former Treasury Secretary*

Figure 9



Source: Credit Suisse Global Financial Strategies. See Appendix B for more detail.

Finally, bond markets have become significantly less liquid in recent years, as banking organizations have significantly reduced their inventories of both U.S. Treasuries and of corporate debt in response to a host of new regulations. Primary dealers reduced their holdings of U.S. Treasuries more than 80% between 2013 and 2015.[22] The average size of a large trade in U.S. investment-grade corporate bonds has declined by more than 30% since 2007, suggesting that it has become more difficult to transact in bond markets without affecting prices.[23] Studies link market liquidity with present and future rates of economic growth through faster capital accumulation and better resource allocation.[24] More critical, perhaps, is the threat that decreased market liquidity poses to financial stability. Studies suggest that a higher level of liquidity in normal times reduces the

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[20] *Examining the Impact of the Volcker Rule on the Markets, Businesses, Investors, and Job Creators: Hearing Before the H. Subcomm. on Capital Markets, Securities, and Investment*, 115th Cong. (Mar. 29, 2017) (statement of Ronald J. Kruszewski, Chair and CEO, Stifel Financial Corp., on behalf of SIFMA) (link).

[21] Patti Domm, *Summers agrees with Dimon: There's a liquidity problem*, CNBC (Apr. 9, 2015) (link).

[22] Liz Capo McCormick & Daniel Kruger, *The Treasury Market's Legendary Liquidity Has Been Drying Up*, BLOOMBERG (Feb. 2, 2015) (link).

[23] BANK OF ENGLAND, FINANCIAL STABILITY REPORT (July 1, 2015) (link).

[24] Guglielmo Maria Caporale, Peter G. A Howells & Alaa M. Soliman, *Stock Market Development and Economic Growth: The Causal Linkage*, 29 J. OF ECON. DEV. (June 2004) (link).

"[I]t would have been surprising for such a major piece of legislation passed in the immediate aftermath of the crisis to have [gotten the mix of restrictions just right]. Usually, a law like the Dodd-Frank Act would have been followed some months later by another law denominated as containing technical corrections, but usually containing some substantive changes deemed warranted by analysis and experience…. And the novelty of many forms of regulations adopted by financial regulators, either in implementing the Dodd-Frank Act or under existing authorities, almost assures that some recalibration and reconsiderations will be warranted on the basis of experience."[27]

– Daniel K. Tarullo, Governor, Federal Reserve

"Many of the statutory provisions and regulations put in place to effect these changes were novel; it is not likely that we would have gotten everything exactly right on the first attempt. This is a good time to step back and ask what changes have worked and where adjustments should be made."[26]

– Jerome H. Powell, Governor, Federal Reserve

likelihood of a liquidity freeze that could lead to a systemic crisis under stress conditions.[25]

D. Now is the Time for Regulatory Rebalancing

It should not be surprising, after almost nine years of intense post-financial crisis regulatory and supervisory changes, that the time has come for a thoughtful assessment of where the balance should be drawn. There has been no systematic or rigorous assessment, on an individual or cumulative basis, of the impact or effectiveness of the many regulatory and supervisory requirements imposed on the financial sector since the financial crisis. The Dodd-Frank Act required financial regulatory agencies to make nearly 400 new regulations, and since 2010, those agencies have rolled out new regulations at a breakneck pace, filling more than 25,000 pages of the *Federal Register* with proposed and final rules.[28] The Dodd-Frank Act's statutory deadlines were often impractical and regulators were left with little time to assess the cumulative impact of how the regulatory framework, both old and new, impacted financial markets, jobs and growth.[29] Given the extent of the new regulations imposed on the financial sector, a thorough and critical review of these requirements is needed to ensure the U.S. financial regulatory framework appropriately balances the goals of promoting economic opportunity and the creation of American jobs while ensuring the stability of the U.S. financial system and protecting depositors, investors and consumers.

SIFMA believes that it is possible to rebalance a number of regulations which impose costs that significantly exceed their likely benefits. In the immediate aftermath of the financial crisis, a sole concern with financial stability above all other policy goals was critical. As financial resiliency has been enhanced, the agencies have often passed regulations without

[25] INTERNATIONAL MONETARY FUND, *Chapter 2: Market Liquidity—Resilient or Fleeting, in* GLOBAL FINANCIAL STABILITY REPORT: VULNERABILITIES, LEGACIES, AND POLICY CHALLENGES: RISKS ROTATING TO EMERGING MARKETS(Oct. 2015) (link).

[26] Jerome H. Powell, Governor, Fed. Reserve, Brief Remarks (Apr. 20, 2017) (link).

[27] Daniel K. Tarullo, Governor, Fed. Reserve, Departing Thoughts (Apr. 4, 2017) (link).

[28] DAVIS POLK & WARDWELL LLP, DODD-FRANK PROGRESS REPORT (Jul. 19, 2016) (link).

[29] Randall D. Guynn & Margaret E. Tahyar, *The Future of US financial regulatory reform in the Trump era*, OXFORD U. PRESS BLOG (Jan. 31, 2017) (link).

"A few themes can guide us in this next phase. First, after years of raising capital and liquidity standards, and of stress tests and living wills, our financial system is much stronger now. We should protect these core reforms and avoid a return to the highly vulnerable system that existed before the crisis. Second, in too many cases new regulation has been inappropriately applied to small and medium-sized institutions. We need to go back and broadly raise thresholds of applicability and look for other ways to reduce burden on smaller firms. Third, the new rule book is excessively complex. We need to look for ways to simplify the rules so that they support our broad goals but also improve the efficiency of regulation. For example, we need to allow boards of directors and management to spend a smaller portion of their time on technical compliance exercises and more time focusing on the activities that support sustainable economic growth. Fourth, we need to continue to strive to provide an appropriate level of transparency to supervised firms and the public regarding our expectations."[31]

– Jerome H. Powell, Governor, Federal Reserve

balancing the costs to job creation and economic growth against the problem sought to be remedied, and in some cases have deemed remote risks to be a justification for major costs associated with a new rule. As a result, agencies have in some cases set regulatory requirements far in excess of levels commensurate with the risk posed by regulated activities or appropriate for the size and type of institution. Regulations intended to discourage excessive risk-taking or de-risk the financial system can also give rise to unintended consequences such as reducing lending, market liquidity and the availability of financial products and services to U.S. consumers and businesses. They can also increase procyclicality, herding behavior and regulatory arbitrage. In particular, unintended consequences that reduce lending disproportionately affect consumers, small and medium-sized businesses and underserved communities. Other requirements may impose excessive compliance burdens because they are unnecessarily complex, require duplicative or extraneous reporting, create barriers to entry for new market participants or have become outdated due to technological change.

Now that the U.S. financial system is significantly stronger and more resilient than it was in 2008, and especially in light of the slow recovery, it is time for policymakers to pause and take stock of which regulations work and which do not to rebalance their approach to financial regulation.[30] By assessing both what the Dodd-Frank Act and its regulatory implementation has done right and where it went wrong, policymakers can find opportunities for bipartisan agreement for reform of laws and regulations that generate high costs while offering no or few corresponding benefits. SIFMA's core recommendations, if enacted, would unlock the dynamism of the U.S. economy and ensure that the United States remains the global financial capital of the world.

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[30] Id.

[31] Jerome H. Powell, Governor, Fed. Reserve, Brief Remarks (Apr. 20, 2017) (link).

E. Recommendations to Promote the Core Principles

TOPICS AND RECOMMENDATIONS	ACTION
1. Regulatory Architecture and Good Governance	
■ FSOC should broaden its focus to promoting jobs, growth and directing the financial regulatory agencies to follow the Core Principles.	Executive Order Congress
■ Simplify U.S. regulatory architecture.	Congress
■ Only one regulator should bring an enforcement action related to a single set of facts.	Executive Order
■ FSOC should ensure that regulations and guidance are fair, transparent and consistent.	Executive Order
■ All Federal financial agencies should be required to perform rigorous cost-benefit analysis.	Executive Order Congress

2. CCAR / Stress Testing and Capital	
CCAR / Stress Testing	
Bases for Assessment of Capital Plan	
■ Eliminate the qualitative assessments of firms' capital plans, which are inherently subjective and discretionary.	FRB Rulemaking
CCAR Assumptions and Structural Elements	
■ Exclude all capital buffers from post-stress minimum capital ratios.	FRB Supervisory
■ Reassess unrealistic assumptions such as continued capital distributions and balance sheet growth in stress and the potential for losses to exceed carrying value. Recalibrate the global market shock and large counterparty default scenarios.	FRB Supervisory
Supervisory Models and Scenarios	
■ Focus on reviewing and evaluating firms' own CCAR/stress testing models in lieu of applying black box, one-size-fits-all supervisory models.	FRB Supervisory
■ Increase the transparency in developing economic scenarios and subject the process to public notice and comment rulemaking. Recalibrate economic scenarios.	FRB Supervisory FRB Rulemaking
Procedural Changes to CCAR	
■ If supervisory modeling and qualitative assessment are retained, modify the timing and sequence of CCAR/stress testing to allow firms time to review of results before planning capital actions.	FRB Rulemaking
■ Reduce operational burden for the FRB and firms by excluding firms under $50 billion in assets, reducing frequency to a two year cycle, eliminating the mid-year requirement and reducing the number of scenarios to two.	Congress FRB Rulemaking

TOPICS AND RECOMMENDATIONS	ACTION
Capital Requirements	
Supplemental Leverage Ratio	
■ Remove excessive calibration in comparison to the international SLR standard.	FRB, FDIC and OCC Rulemaking
■ Modify the exposure measure to more appropriately act as a backstop to the risk-based requirements. For example exclude cash and equivalents, and recognize GAAP offsetting and netting for collateralized transactions.	FRB, FDIC and OCC Rulemaking
G-SIB Surcharge	
■ Eliminate Method 2 entirely or modify aspects of the calculation to restore a level playing field with international standards.	FRB Rulemaking
■ Continue to treat the G-SIB surcharge solely as a buffer requirement.	FRB Supervisory
Risk-Based Capital Requirements	
■ Rationalize the standardized approach; for example, modify the exposure calculation for derivatives and collateralized transactions, and modify certain adjustments and deductions to capital.	FRB, FDIC and OCC Rulemaking
Other Capital Recommendations	
■ Do not use supervisory actions to implement RWA floors or other *de facto* capital requirements without public notice and comment.	FRB Supervisory
■ Delay the implementation of major new capital standards of the Basel Committee, such as the revised standardized approach and the Fundamental Review of the Trading Book.	FRB Supervisory
3. Liquidity	
Liquidity Coverage Ratio	
■ Broaden the HQLA eligibility requirements to reflect the actual market liquidity of assets.	FRB, FDIC and OCC Rulemaking
■ Align the calculation of net cash outflow to level the playing field with the international Basel LCR standard.	FRB, FDIC and OCC Rulemaking
■ Modify excessively conservative and unrealistic cash outflow and inflow rates to reflect actual performance in stressed market conditions.	FRB, FDIC and OCC Rulemaking
■ Eliminate, or postpone and reduce, the public LCR disclosure requirements.	FRB Rulemaking

TOPICS AND RECOMMENDATIONS	ACTION
Net Stable Funding Ratio	
▪ Withdraw the proposed NSFR rule.	FRB, FDIC and OCC Rulemaking
▪ Alternatively, modify and repropose the NSFR for public comment after any changes by the Basel Committee. Any reproposal should recognize the beneficial impact of collateral on funding transactions, reflect the actual stability of funding sources and liabilities, and eliminate or reduce public disclosure requirements.	FRB, FDIC and OCC Rulemaking
Resolution Liquidity Adequacy and Positioning (RLAP) and Resolution Liquidity Execution Need (RLEN)	
▪ Reassess the need for the RLAP standard, which largely duplicates other liquidity requirements.	FRB and FDIC Supervisory
▪ Modify the agencies' guidance on RLAP and RLEN, including by deferring to firms' analysis of inter-affiliate frictions, eliminating excessively conservative assumptions, and recognizing flexibility regarding pre-positioning of liquidity.	FRB and FDIC Supervisory
▪ Ensure that RLAP and RLEN do not become *de facto* liquidity requirements under normal economic conditions.	FRB and FDIC Supervisory

4. The Volcker Rule	
▪ Repeal the statute and rely upon safety and soundness standards as well as capital and liquidity requirements.	Congress
To the extent not repealed, reevaluate the Volcker Rule on a statutory and regulatory basis, consistent with the following: ▪ Recalibrate the Volcker Rule to prohibit stand-alone proprietary trading, and proprietary trading through covered funds, without chilling legitimate market-liquidity-providing activities, such as market making, consistent with traditional safety and soundness standards.	Congress FRB, CFTC, SEC, OCC, and FDIC Rulemaking
▪ Redefine proprietary trading as short-term trading operated by a business unit that is wholly unrelated to financial intermediation, risk management or asset-liability management.	Congress FRB, CFTC, SEC, OCC, and FDIC Rulemaking
▪ Simplify the statute to prohibit only the types of short-term trading that the Volcker Rule was intended to prevent, without an intent-based standard, by establishing a framework that allows for safe harbors and provides banking organizations the flexibility to tailor their risk management and compliance programs to their structure and activities.	Congress

TOPICS AND RECOMMENDATIONS	ACTION
▪ Remove constraints on capital market liquidity by reforming the RENTD requirement in the market making and underwriting exemptions.	Congress FRB, CFTC, SEC, OCC, and FDIC Rulemaking
▪ Encourage prudent risk management by simplifying the risk-mitigating hedging exemption.	Congress FRB, CFTC, SEC, OCC, and FDIC Rulemaking
▪ Limit the definition of covered funds to Section 3(c)(1) or 3(c)(7) funds that are principally engaged in proprietary trading, as redefined above, while limiting bail-outs of sponsored covered funds.	Congress FRB, CFTC, SEC, OCC, and FDIC Rulemaking
▪ Exempt community banks and other small banking entities from the Volcker Rule.	Congress
▪ Designate a single regulator to be responsible for implementing, interpreting and examining compliance with the Volcker Rule.	Congress
▪ Ensure that any reforms to the Volcker Rule do not impose restrictions on an IDI that would not apply to other affiliates of the bank holding company or operate to have a disparate impact on a banking group that utilizes a subsidiary structure instead of a branch structure.	Congress
▪ Reduce complexities and duplicative requirements under the compliance regime by establishing a framework of safe harbors and allow tailored compliance programs.	FRB, CFTC, SEC, OCC, and FDIC Rulemaking

5. Living Wills	
▪ Streamline all requirements and guidance governing living wills into one rule.	FRB and FDIC Supervisory and Rulemaking
▪ A banking organization with no unremediated deficiencies should not have to file a living will annually.	FRB and FDIC Supervisory or Rulemaking
▪ Eliminate the duplicative requirement to file a separate IDI plan.	FDIC Rulemaking
▪ Raise asset threshold for requiring resolution plans to an appropriate higher amount.	Congress or FRB/FSOC
▪ Announce changes in filing dates well in advance.	FRB and FDIC Supervisory

TOPICS AND RECOMMENDATIONS	ACTION
6. Derivatives	
■ Modify Title VII's cross-border framework to reverse market fragmentation by creating a level playing field for U.S. and non-U.S. firms.	CFTC, SEC, FDIC, OCC, FRB, FCA, and FHFA Rulemaking
■ Recalibrate margin and clearing requirements to unlock resources for lending and investment by focusing the requirements solely on what is appropriate to mitigate risk.	CFTC, SEC, FDIC, OCC, FRB, FCA, and FHFA Rulemaking
■ Simplify, harmonize and streamline other Title VII requirements to eliminate unnecessary inconsistencies, overlap and undue prescription.	CFTC and SEC Rulemaking
7. Incentive Compensation	
■ Repeal Section 956 of the Dodd-Frank Act	Congress
To the extent not repealed: ■ Withdraw 2016 reproposed rules and determine that no further regulation is necessary.	FRB, OCC, FDIC, SEC, FHFA and NCUA Rulemaking
8. Key Topics in Banking Regulation	
■ Reduce uncertainty around the definition of control and make guidance transparent.	FRB Supervisory
■ Withdraw reproposed rule on SCCL.	FRB Supervisory
■ Withdraw proposed rule on physical commodities activities.	FRB Supervisory
■ Do not increase capital charges for merchant banking investments.	FRB Supervisory
9. Securitization	
■ Refine CCAR global market shocks applied to securitization positions.	FRB Supervisory
■ Adjust banking and trading book capital requirements for securitization positions and delink regulatory capital and accounting treatment.	FRB, FDIC, OCC Rulemaking
■ Improve treatment of agency mortgage-backed securities and residential mortgage-backed securities/asset-backed securities in LCR.	FRB, FDIC, OCC Rulemaking
■ Revise Reg AB II asset-level data requirements and abandon application to 144A.	SEC Rulemaking
■ Revise risk-retention rules to provide more flexibility and reduce conflicts.	FRB, FDIC, OCC, FHFA, HUD, SEC Rulemaking

TOPICS AND RECOMMENDATIONS	ACTION
■ Exempt securitization special purpose entities from margin posting requirements and the definition of a Volcker Rule covered fund.	FRB, FDIC, OCC, SEC, CFTC Rulemaking
■ Clarify and simplify QM standards and TRID.	CFPB Supervisory
10. Promoting Equity Market Issuance	
■ Extend JOBS Act accommodations to all companies.	Congress
■ Reduce burdens on companies' access to market.	Congress SEC Rulemaking
■ Expand definition of accredited investor.	SEC Rulemaking
■ Amend Rule 144.	SEC Rulemaking
■ Revise Regulation D bad actor disqualification.	SEC Rulemaking
■ Include municipal securities in Level 2B liquid assets.	FRB, FDIC and OCC Rulemaking
11. Enhanced Prudential Standards for Foreign Banking Organizations	
■ Appropriately tailor certain enhanced prudential standards applicable to foreign banking organizations.	FRB Rulemaking
12. DOL Fiduciary Regulation	
■ Rescind the DOL fiduciary rule or at least delay until a full study about its effects is completed.	DOL Rulemaking
■ The SEC should establish a uniform best interests of the customer standard.	SEC Rulemaking

Chapter 1

REGULATORY ARCHITECTURE AND GOOD GOVERNANCE

Relevant Agencies

- CFPB
- CFTC
- FDIC
- FHFA
- FRB
- FSOC
- Insurance expert
- NCUA
- OCC
- SEC
- Treasury

Chapter 1 – Regulatory Architecture and Good Governance

A. Original Problem to be Remedied

The Federal financial regulatory architecture has long been understood to be too complex and to have too many duplicative and overlapping functions. Both the regulators and the financial sector must cope with duplicative regulation, examination, supervision and enforcement, all while dealing with difficult questions of regulatory perimeter and overlap.[1] For example, there are three different banking regulators at the federal level and two different regulators of the derivatives markets.[2]

The financial crisis revealed that the regulatory architecture was no longer aligned to the way that financial markets operate, and one of the main criticisms in the immediate aftermath of the financial crisis was that the fragmented nature of the regulatory architecture meant that there was no single agency with a systemic view into the entire financial sector. The Dodd-Frank Act created the FSOC to monitor financial stability on a system wide basis and increased greatly the Federal Reserve's powers as an umbrella supervisor of complex banking organizations as well as giving it, for the first time, the power to oversee nonbank SIFIs designated as such by the FSOC. It is often forgotten that another policy impulse behind the creation of the FSOC was that it too would set priorities, deal with duplication and complexity and harmonize supervision and regulation among the many overlapping Federal financial regulatory agencies.

Another key policy problem in financial regulation is insufficient commitment to transparency and the rule of law. The prudential nature of

[1]As noted in Michael S. Barr, Howell E. Jackson and Margaret E. Tahyar, FINANCIAL REGULATION: LAW AND POLICY 167 (Foundation Press, 2016): "Multiple studies and bills introduced in Congress, almost too countless to name, have suggested combining and streamlining federal bank regulatory authorities. The first such bill was introduced in 1919 and the most recent one in 2009. Major studies began in 1937 and have been put forth by regulators, Presidential commissions, or others at roughly five-year intervals ever since." For an excellent review of past proposals for reform, see Elizabeth F. Brown, *Prior Proposals to Consolidate Federal Financial Regulators* (Apr. 20, 2015) (link).

[2] The President's Working Group and the FFIEC were attempts to harmonize and coordinate banking regulations and examination practices among the federal banking agencies.

banking supervision, the tradition of confidentiality and the resulting opacity that has long been a part of the bank examination process are in direct tension with the transparency and accountability required by the Administrative Procedure Act. Transparency, notice and comment and the rule of law are too often set aside by prudential banking agencies in favor of *ad hoc*, confidential staff views or supervisory guidance, each delivered without the opportunity for notice and comment or meaningful judicial or open administrative review, that as a practical matter operate as enforceable against regulated institutions. Three examples out of many illustrate the point. The first is Operation Choke Point, which began as an anti-money-laundering effort but, as applied, clearly became an effort to freeze out certain businesses from banking services through the bank examination process under the cloak of secrecy.[3] The second is the unannounced but real change in the CAMELS examination ratings and supervision process as laid out by The Clearing House in its letter to Treasury.[4] The third was the publication by the Federal Reserve of a new set of "Supervisory Expectations for a Capital Adequacy Process" as part of the instructions for the 2015 CCAR submissions, including guidance on critical components such as loss estimation and pre-provision net revenue estimation methodologies and assumptions.[5] An opaque process devoid of notice and comment or meaningful judicial or open administrative review creates a secret set of laws without transparency to the public, legal uncertainty for market actors, and legal penalties without advance notice. Finally, cost-benefit analysis is not properly used by the federal banking agencies.

B. Need for Rebalancing

The FSOC should rebalance its efforts so that, in addition to financial stability, it focuses on fostering jobs and economic growth and encourages the Federal financial regulatory agencies to promote the Core Principles. Too much time has been spent by the FSOC on the designation of just a few

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[3] H. COMM. ON OVERSIGHT AND GOVERNMENT REFORM, FEDERAL DEPOSIT INSURANCE CORPORATION'S INVOLVEMENT IN "OPERATION CHOKE POINT" (Dec. 8, 2014).

[4] The Clearing House , U.S. Treasury Study Response to Executive Order (Apr. 28, 2017); *Bank Capital and Liquidity Regulation Part II: Industry Perspectives: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 114th Cong. (June 23, 2016) (statement of Greg Baer, President, The Clearing House).

[5] Fed. Reserve, *Comprehensive Capital Analysis and Review 2015 – Summary Instructions and Guidance* 17–26 (Oct. 2014).

individual companies as nonbank SIFIs,[6] and not enough time has been spent on other FSOC mandates, such as making recommendations to enhance the efficiency and competitiveness of U.S. banking and capital markets.[7] The President could issue an Executive Order that directs the Treasury Secretary to use his seat on the FSOC to direct the FSOC's agenda in that direction. Congress could also bolster that change by revising the FSOC's mandate to more closely align with the Core Principles.

The FSOC, composed of the heads of each of the Federal financial regulatory agencies, could also strongly encourage the Federal financial regulatory agencies to reduce duplication and complexity. Multiple agencies, each with its own priorities and approaches, have been responsible for many areas of financial regulation, resulting in duplicative and overlapping regulations. When the regulations are joint, the bureaucratic consensus process that creates them results in an overly complex regulation. In other instances, agencies pass rules without coordination and without assessing the cumulative impact of rules of other agencies or whether the rules work at cross-purposes with one another. Similarly, the same financial institution can be subject to examination by multiple regulators with overlapping supervisory authority and can be the object of enforcement action and duplicative, disproportionate and uncoordinated penalties by multiple agencies on the same set of facts. As a result, there is a web of rules, supervisory guidance, examinations and enforcement actions that are overly complex compared to legislative goals and that are irrationally applied, imposing unnecessary costs on financial activities that are ultimately borne by customers, counterparties and the economy as a whole. No other country in the world has the degree of financial regulatory overlap, duplication and complexity as exists in the United States.

The agencies have often passed regulations, however, without balancing the costs to job creation and economic growth against the problem sought to be remedied. In many cases, an agency has deemed even remote risks to be a sufficient justification for major costs associated with a new rule. As a result, agencies have in some cases set regulatory requirements far in excess

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[6] SIFMA supports the Presidential Memorandum of April 21, 2017 calling for Treasury to conduct a review of the FSOC determination processes. WHITE HOUSE, PRESIDENTIAL MEMORANDUM FOR THE SECRETARY OF THE TREASURY (Apr. 21, 2017).

[7] Dodd-Frank Act § 112(a)(2)(D) established an FSOC mandate "to advise Congress and make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets."

of levels commensurate with the risk posed by regulated activities or appropriate for the size and type of institution.

"[T]he new rule book is excessively complex. We need to look for ways to simplify the rules so that they support our goals but also improve the efficiency of regulation….We need to continue to strive to provide an appropriate level of transparency to supervised firms and the public regarding our expectations. Some aspects of the new regulatory program are proving unnecessarily burdensome and should be better tailored to meet our objectives."[8]

– Jerome H. Powell, Governor, Federal Reserve

Finally, financial regulators have increasingly used their supervisory powers in ways that interfere with the roles and relationships of boards and management. Examiners have become inappropriately influential in the board rooms of supervised entities through either attendance or the review of board minutes. Examiners have decided views on a number of corporate governance issues, such as management reporting lines, board committee jurisdiction and meeting agendas. Supervised entities often feel obliged to comply with examiners' views even though they have not been adopted as rules through a normal notice and comment process, for fear of a negative CAMELS management rating.[9]

Regulators have also established through rules and guidance a lengthy checklist of matters that they require bank boards of directors to review, thereby blurring the line between board and management roles and micro-managing where boards and management should focus their attention.[10] These requirements have put a heavy burden on the board to verify and take responsibility for an ever-increasing number of operational issues in a way that inappropriately erases the distinction between oversight (a board responsibility) and operational management (a management responsibility) and that is beyond the reasonable capacity of outside directors. Most critically, the emphasis on operational checklists leaves less time for boards to focus on strategy, risk and succession, key concerns of board oversight.

C. Proposed Recommendations

Today, with the overwhelming majority of Dodd-Frank regulations adopted and financial stability gains achieved, regulatory agencies should ensure that their mandates are carried out efficiently and in accordance with the rule of law. Core Principles (f) and (g) call for a regulatory architecture that is rational and accountable to the American public and for regulations that

[8] Jerome H. Powell, Governor, Fed. Reserve, Brief Remarks (Apr. 20, 2017) (link).

[9] The Clearing House, U.S. Treasury Study Response to Executive Order (Apr. 28, 2017).

[10] THE CLEARING HOUSE, ANNEX A, U.S. BANK REGULATORY RELATED MATTERS TO BE ADDRESSED BY THE BOARD OR BOARD COMMITTEE PURSUANT TO STATUTE, REGULATION OR AGENCY GUIDANCE (May 2016) (link).

> "After the crisis, there was a broad increase in supervisory expectations for these boards. But it is important to acknowledge that the board's role is one of oversight, not management. We need to ensure that directors are not distracted from conducting their key functions by an overly detailed checklist of supervisory process requirements. Rather, boards of directors need to be able to focus on setting the overall strategic direction of the firm, while overseeing and holding senior management accountable for operating the business profitably, but also safely, soundly, and in compliance with applicable laws. We are currently reassessing whether our supervisory expectations for boards need to change to ensure that these principles, and not an ever-increasing checklist, are the basis of our supervisory work related to boards."[11]
>
> *– Jerome H. Powell, Governor, Federal Reserve*

are efficient, effective and appropriately tailored. SIFMA believes that these goals translate into a regulatory regime guided by the rule of law, with an emphasis on transparency, advance notice and legal certainty.

The following proposals would improve the governance and practices of Federal financial regulatory agencies with respect to rule-making, guidance, examinations, supervision and enforcement, thereby enhancing transparency to the public and achieving greater certainty for market actors:

- The FSOC should broaden its focus beyond financial stability to invest resources to a greater extent on the following existing statutory mandates set forth in Section 112(a)(2) of the Dodd-Frank Act in order to reduce multiple-agency inefficiency and to coordinate and direct supervisory policies to promote the Core Principles:
    - Facilitate information-sharing and coordination among the member agencies regarding financial services policy, rulemaking, examinations, reporting and enforcement;
    - Monitor domestic and international financial regulatory proposals and advise Congress and make recommendations in such areas that will enhance the integrity, efficiency, competitiveness and stability of the U.S. banking and capital markets; and
    - Recommend to the agencies general supervisory priorities and principles and play a role in ensuring that regulatory standards are fair and implemented consistently by all supervisory authorities.
- The U.S. regulatory architecture should be simplified. Congress should give the FSOC a new mandate to assign one regulator as primary regulator on any issue on which multiple conflicting and overlapping regulatory jurisdiction exists today.
- All Federal financial agencies should follow the principles of transparency, public accountability and the rule of law.
- All Federal financial agencies, both executive and independent, should be required to perform a rigorous cost-benefit analysis before proposing a new rule.[12] Agencies should be directed that their cost-benefit

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[11] Jerome H. Powell, Governor, Fed. Reserve, Brief Remarks (Apr. 20, 2017) (link).

[12] Executive Order 12866 requires executive agencies to perform cost-benefit analysis when proposing new rules.

analysis must take into account, among other factors, the impact of the proposed rule on job creation and economic growth and must seek the appropriate balance between that impact and financial stability considerations.

  - All regulatory agencies, both executive or independent, should be required to present in notice of proposed rulemakings all material evidence considered in determining to propose the rule and substantial information, including information forming the basis of the cost-benefit analysis, allowing the public to meaningfully assess the proposed rule, thereby restoring transparency and public accountability to the rule-making process.

- Agency guidance that establishes new substantive legal requirements or interpretations that could not be reasonably inferred from existing rulemaking should be subject to notice and public comment and should not be the basis for adverse regulatory actions against a financial actor retroactively for past acts or omissions, but only prospectively with respect to acts or omissions occurring after comments have been considered and the guidance formally adopted.

- Agency supervision should be based on clear, written rules issued in accordance with the Administrative Procedure Act providing financial actors advance notice of compliance expectations.

- Supervision and enforcement should be measured, consistent and apolitical.

- Enforcement action related to a single set of facts should be brought by one regulator only.

- Supervisors should step back from playing the role of board of directors. Boards should not be required by supervisors to micro-manage, and routine tasks that are better performed by management should be reallocated from boards to management.

Chapter 2

STRESS TESTING AND CAPITAL REQUIREMENTS

Relevant Agencies

- FDIC
- FRB
- Treasury

"While the SLR is intended to be a backstop measure to risk-based requirements, for many institutions it may become the binding constraint. This has implications for the smooth functioning of the short-term funding markets, particularly the repo market for U.S. government securities."[1]

– Robert Toomey, Managing Director, SIFMA

Chapter 2 – Stress Testing and Capital Requirements

With the adoption of new U.S. capital requirements since the financial crisis, banking organizations, depending on their size, are now subject to multiple risk-based capital ratios, multiple leverage ratios, multiple capital buffers and multiple TLAC ratios. These requirements are extremely complex, are based on excessively conservative and risk-insensitive assumptions, and in many respects are calibrated above international standards. As a result, banking organizations hold excessive levels of capital that are increasingly disconnected from the level of risk they incur.

Although these levels of capital have undoubtedly made banking organizations more resilient to the risk of material financial distress, they come at a cost. The more capital banking organizations are required to hold, the less they are able to deploy earnings into credit intermediation and capital markets activities that promote the availability of credit and the liquidity of credit and capital markets. In short, higher capital comes at the expense of a greater contribution by banking organizations to U.S. economic growth.

A. Original Problem to be Remedied

The financial crisis made it apparent that many banking organizations,[2] both those headquartered in the United States and in other countries, did not have sufficient capital or liquidity. The Basel III capital requirements were designed to address inadequacies in the quantity and quality of capital maintained by internationally active banking organizations around the globe. The U.S. implementation of these international standards, known as U.S. Basel III, departs in a number of ways from the standards agreed upon by the Basel Committee.

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[1] *The Impact of Regulations on Short-Term Financing: Hearing Before the H. Subcomm. on Capital Markets*, 115th Cong. (Dec. 8, 2016) (statement of Robert Toomey, Managing Director, SIFMA) (link).

[2] In this Chapter, the term "banking organization" means a bank holding company, bank, savings association or savings and loan holding company subject to the U.S. Basel III capital rules, or a U.S. bank holding company or intermediate holding company of a foreign banking organization subject to the Federal Reserve's CCAR/stress testing requirements.

Stress testing began during the financial crisis as an exercise to demonstrate that U.S. banking organizations had the financial strength to weather a prolonged recession. Section 165(i) of the Dodd-Frank Act codified the requirement for the Federal Reserve to conduct annual analyses of capital adequacy under stressed conditions and for banking organizations with more than $10 billion in total assets to conduct company-run stress tests. The Federal Reserve also adopted capital planning requirements as an additional supervisory tool to ensure that U.S. banking organizations' proposed capital distributions over a nine-quarter time horizon would, even under severely stressed conditions, enable each banking organization to meet or exceed its minimum capital requirements and continue to maintain ready access to funding, meet its obligations and serve as a credit intermediary.[3]

Complementing capital and CCAR/stress testing requirements, liquidity and funding requirements aim to ensure that regulated banking organizations have access to sufficient liquidity resources to cover their short-term funding needs, including in times of stress, thereby insulating the banks against runs and the banking system against contagion and otherwise promoting the safety and soundness of individual banking organizations. Whereas capital requirements focus on the long-term sufficiency of loss-absorbing funding as a cushion against potential losses arising from risky assets and other exposures, i.e., solvency risk, liquidity requirements such as the LCR and the Federal Reserve's liquidity stress testing requirements focus on near-term sufficiency of cash and low-risk assets to meet short-term obligations that could arise if the organization were to lose access to short-term funding, i.e., run risk.

B. Need for Rebalancing

SIFMA supports many of the post-crisis regulatory reform efforts in the areas of capital, stress testing and liquidity. Higher capital and liquidity requirements, combined with stress testing requirements, have helped make the U.S. banking system stronger and more resistant to severe financial distress and helped to restore market confidence in the U.S. financial system following the crisis. SIFMA believes that the combination of capital, stress testing and liquidity requirements have undoubtedly contributed to

[3] 12 C.F.R. § 225.8.

strengthening the U.S. banking sector and making it significantly more resilient against material financial distress and, in the worst case, making institutions resolvable without putting U.S. taxpayers at risk. These changes have enhanced U.S. financial stability. These requirements support the objective of Core Principle (b) (prevent taxpayer-funded bailout), and, in principle, are supposed to support Core Principle (c) (foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures).

"[T]he novelty of many of the forms of regulations adopted by financial regulators, either in implementing the Dodd-Frank Act or under existing authorities, almost assures that some recalibration and reconsiderations will be warranted on the basis of experience."[4]

– Daniel K. Tarullo, Governor, Federal Reserve

SIFMA believes that now is the appropriate time to evaluate whether and to what extent there are aspects of the U.S. capital, CCAR/stress testing and liquidity requirements that are excessively conservative and impose costs on the U.S. financial sector that outweigh their benefits, especially in terms of fostering economic growth and vibrant financial markets. SIFMA believes that there are a number of flaws in the current and proposed capital, CCAR/stress testing and liquidity requirements that work against Core Principle (c) and other Core Principles, and that work at cross-purposes with one another.

1. Capital Requirements Are Increasingly Risk-Insensitive and Excessively Conservative (Core Principles (c) and (f))

Regulatory capital requirements should be based on the principle that taking greater risk requires greater capital. Completely risk-insensitive leverage capital measures, such as the SLR, are becoming the binding capital measures for many banking organizations, and the standardized risk-based capital requirements do not permit sufficient use of more risk-sensitive methodologies, especially in calculating exposures for derivatives and other collateralized transactions. As a result, the amount of required capital is increasingly unrelated to the level of risk taken, which defeats the principle of correlation between risk and capital and could lead to insufficient or excess capital levels, depending on prevailing economic conditions. These trends are exacerbated by excessively conservative and unrealistic assumptions built into the requirements, which creates a one-way ratchet toward higher amounts of capital and liquidity without adequate consideration of the effects on lending, market liquidity and other contributors to banking and capital markets and economic growth.

[4] Daniel K. Tarullo, Governor, Fed. Reserve, Departing Thoughts (Apr. 4, 2017) (link).

> "If one were asked to choose from a systemic, 'macroprudential' perspective between regulators having as their imperative (i) ensuring all banks allocate their capital based on the same view of the risk of each asset, or (ii) ensuring that all banks allocate their capital based on different views of the risk of each asset, history would appear to argue for the latter."[6]
>
> *– Greg Baer, President, The Clearing House Association*

> "Because CCAR is the binding capital requirement, banks will tend to shift lending away from sectors with higher implicit capital requirements under CCAR . . . toward sectors with lower capital requirements. For example, the results of our analysis are consistent with the slower growth of small business loans and mortgage loans at large banks, which have higher implicit capital requirements under CCAR."[5]
>
> *– The Clearing House, The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test*

2. Capital and Liquidity Requirements Have Been Calibrated At Excessively Conservative Levels by U.S. Regulators Compared to International Standards (Core Principles (d) and (f))

The U.S. capital and liquidity requirements systematically reflect more conservative and less risk-sensitive assumptions than the Basel Committee on Banking Supervision's international standards and require U.S. banking organizations to hold more capital and liquidity than their non-U.S. counterparts that are subject to non-U.S. rules more closely aligned with the international standards. Deviations from international standards may be appropriate in certain instances but the U.S. banking agencies have not performed a proper quantitative analysis showing the need for these deviations or a proper cost-benefit analysis evaluating their effect on banking and capital markets activities and economic growth.

3. Complex, Overlapping and Duplicative Rules Have Produced Cumulative and Excessively High Requirements as well as Contradictory Incentives (Core Principles (c), (f) and (g))

Regulatory capital requirements, for example, are set by a combination of some or all of the Federal Reserve's capital rules for holding companies; the Federal Reserve's, OCC's or FDIC's capital rules for state member banks, national banks or state non-member banks, respectively; the Federal Reserve's capital planning and stress testing rules; for the U.S. G-SIBs and U.S. IHC subsidiaries of foreign G-SIBs, the Federal Reserve's TLAC rule; and the Federal Reserve's and FDIC's joint guidance on resolution planning. Because CCAR and stress testing require banking organizations to meet or exceed their minimum capital requirements under hypothetical, severely stressed economic conditions, the post-stress capital requirements have become, for many firms, the real binding capital constraints, which makes it all the more important not to inflate these requirements by adding

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[5] THE CLEARING HOUSE, THE CAPITAL ALLOCATION INHERENT IN THE FEDERAL RESERVE'S CAPITAL STRESS TEST (Jan. 30, 2016) (link).

[6] *Bank Capital and Liquidity Regulation Part II: Industry Perspectives: Hearing Before the S. Committee on Banking, Hous. & Urban Affairs*, 115th Cong. (June 23, 2016) (statement of Greg Baer, President, The Clearing House Association) (link).

capital buffers and risk-insensitive measures such as the SLR to the mix of post-stress requirements.

> "The Federal Reserve's CCAR stress test is imposing dramatically higher capital requirements on certain asset classes – most notably, small business loans and residential mortgages – than bank internal (Fed approved) models and Basel standardized models."[7]
>
> *– The Clearing House, The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test*

The Federal Reserve's CCAR supervisory models play a significant role in banking organizations' capital-allocation and underwriting decisions. The one-size-fits-all supervisory models used by the Federal Reserve to estimate losses in CCAR/stress testing run the risk of fostering a regulatory monoculture, incentivizing large banking organizations to herd into, or avoid, the same asset classes. Not only does such herding create the potential for new sources of systemic risk, but some evidence suggests that CCAR has particularly disincentivized lending to homeowners and small businesses. Likewise, in the one-size-fits-all liquidity model imposed by the LCR, the limited pool of instruments qualifying as HQLA leads to increased concentration and correlation risk and embeds a regulatory preference for public-sector debt over private-sector instruments that can contribute to economic growth. As discussed in Chapter 9, the impact has hit securitization especially hard.

> "[I]n the context of the stress test, banks must effectively hold as much as 140% more capital for a small business loan than for a loan to a larger firm."[8]
>
> *– Robert G. Wilmers, CEO, M&T Bank*

Liquidity requirements can work at cross-purposes with capital requirements, creating counterproductive incentives for some banking organizations to curtail lending. For example, a bank that holds increased amounts of HQLAs, such as U.S. Treasuries, in order to comply with the LCR must also hold a corresponding increased amount of Tier 1 capital to comply with the Tier 1 leverage ratio and the SLR. As a result, instead of providing an incentive for banking organizations merely to add more HQLAs to their existing exposures, the liquidity requirements, acting in combination with risk-insensitive leverage capital requirements, create an incentive for banking organizations to reduce their holdings of non-HQLA exposures to compensate for the increase in HQLAs in order not to be penalized by the capital requirements. Banking organizations are incentivized to reduce holdings of loans, private-sector corporate debt and equities—asset classes that contribute to private sector economic growth and typically yield higher returns in exchange for higher risks—in favor of government and government agency debt, asset classes that represent public-sector financing with low returns and low risk. The effect is for banking organizations to reduce their role in taking the risks inherent in

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[7] THE CLEARING HOUSE, THE CAPITAL ALLOCATION INHERENT IN THE FEDERAL RESERVE'S CAPITAL STRESS TEST (Jan. 30, 2016) (link).

[8] Letter from Robert G. Wilmers, CEO, M&T Bank, to Shareholders (Mar. 9, 2017) (link).

engaging in banking and capital markets activities, i.e., credit intermediation and maturity transformation, as discussed in Chapter 9.

4. Discretionary and Non-Transparent Criteria Create Unnecessary Uncertainty and Unpredictability in Banking Organizations' Ability To Comply with the Requirements and Give the Federal Reserve Significant Discretionary Authority in Determining the Extent to which Banking Organizations Are Permitted To Pay Dividends or Return Capital to Their Shareholders (Core Principles (f) and (g)

> "[The lack of transparency] may limit understanding of the CCAR assessments and hinder public and market confidence in the program and the extent to which the Federal Reserve can be held accountable for its decisions."[9]
>
> *– Government Accountability Office, Nov. 2016*

There is an absence of transparency throughout the CCAR/stress testing processes: in the criteria used by the Federal Reserve to develop its economic scenarios and assumptions, in its supervisory models to determine whether banking organizations meet the quantitative capital requirements on a stressed basis and in the criteria to determine whether banking organizations meet the qualitative supervisory expectations. This opacity leads banking organizations to propose lower distributions of capital to shareholders and to hold additional capital buffers on top of the post-stress minimum capital requirements, in order to reduce the risk of an objection from the Federal Reserve.

> "The cumulative effects of a series of regulations have made it substantially more difficult and expensive for banks and large securities dealers to act as market makers."[10]
>
> *– Douglas J. Elliott, Fellow, Brookings Institute*

Fixing the flaws in each individual set of regulations—capital, liquidity or CCAR/stress testing—is not the entirety of the task. It is equally important to address the **cumulative impact** of these requirements, including the extent to which requirements are reflected in the regulators' assumptions, instructions or guidance to implement the rules, e.g., the Federal Reserve's assumptions and instructions for CCAR/stress testing, the Federal Reserve and FDIC's RCEN and RLEN requirements in resolution planning guidance, rather than in the rules themselves, and the extent to which the requirements may work at **cross-purposes** with one another. For a discussion of other aspects of living wills, see Chapter 5.

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[9] GOV'T ACCOUNTABILITY OFFICE, HIGHLIGHTS OF FEDERAL RESERVE: ADDITIONAL ACTIONS COULD HELP ENSURE THE ACHIEVEMENT OF STRESS TEST GOALS 2 (Nov. 2016).

[10] Douglas J. Elliott, *Is There a Problem with Liquidity in the Financial Markets?*, BROOKINGS UP FRONT (June 16, 2015) (link).

The recommendations that follow relate to the CCAR/stress testing and capital requirements. Chapter 3 sets forth SIFMA's recommendations for improving liquidity requirements. Within these topics, SIFMA will discuss the degree to which each set of requirements, when combined with the other requirements, can cumulatively ratchet up the requirements or create conflicting and contradictory incentives. These recommendations can, in most cases, be accomplished through agency actions, without the need for legislative changes; the discussion below notes specific instances in which a legislative repeal or amendment may be necessary.

C. Proposed Recommendations

Because for many firms the binding capital constraints are not the U.S. Basel III capital ratios required to be well-capitalized or adequately capitalized, but the post-stress minimum capital ratios they are required to meet as a result of CCAR, the recommendations below address: first, proposed changes to the CCAR/stress testing requirements, and second, proposed changes to the capital rules, both as they are incorporated into CCAR/stress testing and as they are applied in the ordinary course.

1. CCAR and Stress Testing Requirements

Background and Summary of Requirements

- Large U.S. banking organizations are subject to stress testing and capital planning requirements collectively referred to as CCAR/stress testing. The CCAR/stress testing requirements have two distinct but related components: a set of stress tests, required under the Dodd-Frank Act, conducted annually by the Federal Reserve and semiannually by the banking organization itself (DFAST) and an annual comprehensive capital analysis and review (CCAR) conducted by the Federal Reserve that considers each banking organization's capital ratios on a post-stress basis *and* assuming that the organization distributes capital according to its planned capital actions, i.e., dividends, share repurchases and, if applicable, any capital-raising actions.

- Both CCAR and supervisor-run stress tests under DFAST are based in part on adverse and severely adverse stress scenarios published and revised annually by the Federal Reserve without public notice and comment. In addition, the largest banking organizations must incorporate additional stress scenarios into their CCAR capital plans known as the global market shock and counterparty default scenarios, which assume these largest organizations are subject to even further losses. CCAR and supervisory DFAST results are based on the Federal Reserve's proprietary models of how certain assets and liabilities will perform under stressed conditions. The Federal Reserve also directs banking organizations to make certain assumptions for purposes of CCAR, including assumptions about how the organization itself would react to the hypothetical stress scenario.

- DFAST does not impose any limitations on capital distributions or other *de facto* capital requirements and is the only stress testing mandated by statute. CCAR, on the other hand, has evolved into a *de facto* capital requirement, since the Federal Reserve can object to a banking organization's capital plan on either qualitative or quantitative grounds and therefore impose binding limits on the organization's ability to distribute capital to its shareholders, even if the organization otherwise satisfies all of its capital requirements and buffers under current economic conditions or the baseline economic scenario. For many banking organizations, these limits under CCAR are their most binding capital requirement. Unlike DFAST, the Federal Reserve is not required by statute to conduct CCAR.

"In the U.S., the six largest banks are required to conduct a global market shock (GMS) on their trading book. For CCAR-2015, the Fed specified about 24,000 parameters across about 20 categories such as equities, FX, rates, energy and commodities, securitized products, credit correlation and so on. . . . The challenges of building a model that can generate a set of coherent scenarios at such high dimensions are formidable!"[11]

– Til Schuermann, Stress Testing in Wartime and in Peacetime

Problems with Implementation

- **Excessively conservative requirements.** Certain behavioral assumptions and structural features of CCAR are incoherent, counterfactual and unrealistic and result in much higher *de facto* capital requirements than would be the case using realistic assumptions and instructions. For example, banking organizations are instructed to assume that they would continue to make all of their planned share repurchases and pay all of their planned dividends, and that their balance sheets would continue to expand, in severely stressed conditions notwithstanding large losses.

  The Federal Reserve's supervisory scenarios for CCAR and DFAST reflect unreasonably extreme economic shocks, especially for firms

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[11] Til Schuermann, *Stress Testing in Wartime and in Peacetime*, *in* STRESS TESTING AND MACROPRUDENTIAL REGULATION: A TRANSATLANTIC ASSESSMENT (Ronald W. Anderson ed., 2016) (link).

subject to the additional global market shock and counterparty default scenarios.

- **Discretionary and non-transparent criteria.** The Federal Reserve uses various models to project stressed losses for categories of assets, e.g., residential mortgage loans, for a given set of macroeconomic indicators comprising a stress scenario. These models are referred to as the supervisory models. The disparity between supervisory models developed by the Federal Reserve and internal models used by private firms can be significant, with supervisory models "imposing dramatically higher capital requirements on certain asset classes—most notably, small business loans and residential mortgages."[12] Thus, the supervisory models are of central importance to the *de facto* capital requirements that apply to particular asset types. These models, however, have been developed, tested and implemented by the Federal Reserve with limited, and so far insufficient, disclosure, transparency and public accountability.

  The supervisory scenarios are designed, published and revised by the Federal Reserve without public notice and comment on their reasonableness or appropriateness. As such, there are no legal or practical guardrails on how adverse these scenarios could be, leaving the Federal Reserve to design these discretionary scenarios without any transparency or public accountability.

  The Federal Reserve's supervisory expectations of firms' capital planning processes and procedures are vague and change without advance notice, transparency or public accountability. For example, in the public 2016 CCAR results, the Federal Reserve objected on qualitative grounds to two capital plans, citing vague deficiencies such as "material unresolved supervisory issues" and assumptions and analyses that are "not reasonable or appropriate."[13] These changes in expectations and feedback sometimes appear to reflect changes in examination teams and other personnel.

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[12] THE CLEARING HOUSE, THE CAPITAL ALLOCATION INHERENT IN THE FEDERAL RESERVE'S CAPITAL STRESS TEST 2 (Jan. 2017).

[13] FED. RESERVE, COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW 2016: ASSESSMENT FRAMEWORK AND RESULTS 15 (June 2016).

- **Impact of regulatory models on market pricing and the model monoculture.** The combination of the ability of the Federal Reserve to issue an objection to a firm's capital plan if post-stress capital ratios do not satisfy minimum requirements, and the determination of the post-stress capital ratios based on a one-size-fits-all supervisory model, leads to the following consequences:

    - Each firm has an incentive to attempt to reverse-engineer the supervisory model in order to plan its capital actions so that the risk of an objection is minimized. This has the inevitable, if unintended, consequence of causing firms to internalize the supervisory models when allocating capital to products and business lines, which in turn affects the real-world price-setting process. Financial services should be priced based on the market-based assessment of risks by private actors, not by regulators' risk models.

    - The reliance on supervisory models contributes to a risk-modeling monoculture, which can cause herding into asset classes and contribute to systemic risks.

> "As regulatory requirements – and in particular, capital and liquidity requirements – become increasingly stringent and granular, they run the risk of creating such powerful allocative incentives that they effectively drive capital allocations. There are serious concerns with such an arrangement. First, markets generally are more efficient in evaluating financial risk than governments, and in any event are quicker to react to changes in risk. Second, government mandated outcomes tend to herd risk and thereby create concentrations."[14]
>
> *– Greg Baer, President, The Clearing House Association*

- **Unwarranted compliance burden.** The compliance burden for CCAR is too high to justify all of the benefits from the process. For certain categories of banking organizations, CCAR and stress testing are unwarranted. For the larger banking organizations, the frequency and sequence of CCAR/stress testing is too burdensome relative to the incremental benefits compared to a less frequent and more measured approach.

Recommendations

- **Bases for Assessment of Capital Plan**

    - **Elimination of qualitative assessment of a firm's capital plan.** The Federal Reserve should be precluded from objecting to a BHC's capital plan solely on qualitative grounds, which are inherently subjective and discretionary.

[14] *Bank Capital and Liquidity Regulation Part II: Industry Perspectives: Hearing Before the S. Committee on Banking, Hous. & Urban Affairs*, 115th Cong. (June 23, 2016) (statement of Greg Baer, President, The Clearing House Association) (link).

- The relief from the qualitative assessment that was recently provided to large and noncomplex CCAR firms should be extended to all CCAR firms. There is no difference in the inherent subjectivity and discretionary application of a qualitative assessment between large and noncomplex firms and other firms. The quality of large and complex banking organizations' capital planning processes would still be reviewed as part of the Federal Reserve's ongoing supervision of each firm.

- In the alternative, the Federal Reserve should be required to establish an objective, transparent standard for its qualitative assessments, subject to public notice and comment, and to provide a clear rationale for any qualitative objection.

"[T]he time may be coming when the qualitative objection in CCAR should be phased out, and the supervisory examination work around stress testing and capital planning completely moved into the normal, year-round supervisory process, even for the G-SIBs."[15]

– Daniel K. Tarullo, Governor, Federal Reserve

- **CCAR Assumptions and Structural Elements**

  - **Exclusion of capital buffers from post-stress minimum capital requirements to allow the buffers to absorb losses as intended**. Exclude all forms of capital buffers, such as the G-SIB surcharge, the enhanced SLR, if it is not eliminated, and the countercyclical capital buffer, if deployed, from the minimum capital ratios firms are required to meet in CCAR/stress testing.

    - These buffers are not part of minimum capital requirements under the U.S. Basel III capital rules and should not be treated as minimum requirements for CCAR/stress testing purposes.

      — Capital buffers are implemented as incremental requirements, not minimum requirements. Under the U.S. Basel III capital rules, capital buffers may be consumed in times of stress without triggering prompt corrective action or otherwise resulting in the banking organization failing to satisfy its minimum capital ratios. Rather, if a banking organization experiences losses sufficient to deplete its capital buffers below the applicable levels, the organization would become subject to a graduated series of restrictions

"[P]otential adjustments [to CCAR] include changes to the assumptions about the pace of a firm's planned dividend and share repurchases, and how a firm in a stressed environment would likely manage its balance sheet and business footprint."[16]

– William Dudley, President and CEO, Federal Reserve Bank of New York

[15] Daniel K. Tarullo, Governor, Fed. Reserve, Departing Thoughts (Apr. 4, 2017) (link).

[16] William Dudley, President and CEO, Fed. Reserve Bank of N.Y., Principles for Financial Regulatory Reform (Apr. 7, 2017).

on capital distributions and executive bonus payments that are designed to conserve capital.[17]

— Requiring firms to maintain any of these buffers in stressed conditions is to create a *de facto* duplicative capital requirement to maintain a buffer on top of a buffer.

□ The G-SIB surcharge is already calibrated based on indicators that measure the same risks on which CCAR's global market shock and large counterparty default scenarios are based. For example, trading assets such as derivatives and securities financing transactions are subject to severe losses under CCAR's global market shock and large counterparty default scenarios, but are also weighted heavily in the G-SIB surcharge methodologies. Including the G-SIB surcharge in CCAR would therefore duplicate the capitalization of those risks.

o **Reassessment and recalibration of required CCAR/stress testing assumptions to avoid unrealistic and illogical results and internal contradictions.** The Federal Reserve should undertake a comprehensive reassessment of the assumptions it requires firms to make in their CCAR/stress testing submissions or permit firms to develop their own assumptions that would be reviewed as part of the Federal Reserve's quantitative assessment to eliminate or modify assumptions that are unrealistic or internally contradictory, such as:

□ CCAR should not assume that firms would continue to make planned capital distributions in a severely adverse stress scenario.

— This assumption is unrealistic because it implies that firms will not themselves seek to conserve capital or that the regulators will not use supervisory tools to require firms to conserve capital in times of stress, such as requiring firms to follow their recovery plans and enforcing limits on capital distributions under the capital buffer framework.

[17] 12 C.F.R. § 217.11 (treating the sum of the 2.5%, an institution's applicable countercyclical capital buffer and its G-SIB surcharge as the level against which the institution's actual capital conservation buffer is compared to avoid payout ratio limitations).

- CCAR should not assume that firms' balance sheets, or total leverage exposure under the SLR, would grow in stress scenarios.
  - This assumption is not only unrealistic, but violates basic accounting principles. Losses must be allowed to reduce the value of impaired assets on the balance sheet and a firm must be allowed to adjust its capital requirements accordingly, i.e., lower RWAs, on-balance sheet assets or total leverage exposure would in reality require less capital.
- For any investment or position, the sum of the hypothetical stressed loss and the amount of its carrying value that is deducted from capital should not exceed the original carrying value of the investment or position.
- The underlying assumptions for the instantaneous global market and large counterparty shocks should be recalibrated to be more realistic and consistent with the severely adverse scenario, especially with respect to timing of losses, and to reflect realistic recovery rates, especially for secured exposures.
  - The global market shock and large counterparty default scenarios assume that both a market move equivalent to a six-month crisis and the default of each organization's largest trading counterparty occur in a single day with no ability to manage liquidity risks. This assumption is not at all representative of how market stress unfolds.

- **Supervisory Models and Scenarios**
  - **Use of firms' internal models instead of supervisory models or greater transparency of supervisory models.** Instead of applying its own black-box supervisory models, the Federal Reserve should focus on reviewing, assessing and evaluating—and giving feedback on how to improve—firms' own CCAR/stress testing models.
    - The Office of the Inspector General and the Government Accountability Office have identified significant shortcomings in Federal Reserve modeling practices, testing, governance, and staffing, the likes of which "the Federal Reserve [has] typically . . . characterized as matters requiring immediate

attention or as matters requiring attention" when identified at supervised institutions.[18]

- Greater reliance on firms' own models, which are and would continue to be subject to rigorous supervision, would ensure capital levels are set based on more granular analyses by firms of their idiosyncratic portfolios and product types, rather than a one-size-fits-all supervisory model developed without the benefit of firms' own data on the historical performance of particular products under stressed conditions.

- This approach would free up Federal Reserve resources to focus on evaluating the robustness of individual firms' models, and comparing them to each other. This would also address the Office of Inspector General's finding that the Federal Reserve substantially understaffs model validation relative to sector practice.[19]

- This approach would avoid incentivizing the herding of firms towards trying to replicate the Federal Reserve's models, which contributes to the very risk the Federal Reserve states it wants to avoid.

- In the alternative, if the Federal Reserve's supervisory modeling is not eliminated from CCAR/stress testing, the Federal Reserve should disclose more information about its supervisory models and methodologies, consistent with the GAO's recommendations:[20]

  — Any CCAR/stress testing supervisory methodologies, including models, assumptions and parameters, should be transparent and subject to public notice-and-comment rulemaking procedures. They should not be imposed through non-transparent supervisory processes.

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[18] FED. RESERVE OFFICE OF INSPECTOR GENERAL, AREAS OF IMPROVEMENT FOR SUPERVISORY STRESS TESTING MODEL VALIDATION ACTIVITIES 9 (Oct. 29, 2015).

[19] Id. at 8.

[20] GOV'T ACCOUNTABILITY OFFICE, FEDERAL RESERVE: ADDITIONAL ACTIONS COULD HELP ENSURE THE ACHIEVEMENT OF STRESS TEST GOALS 93–94 (Nov. 2016).

- — The Federal Reserve should provide periodic updates on the range of best practices and lagging practices it observed in the most recent CCAR/stress testing cycle, in order to make transparent its changing expectations, and should provide more timely feedback in response to banking organizations' questions or interpretive requests.

- o **Recalibration of, and greater transparency in process of developing, economic scenarios**

  - □ Calibrate economic scenarios to reflect assumptions that are conservative, but not completely unrealistic.

    - — For example, the 2017 supervisory severely adverse scenario features a peak unemployment rate of 10% occurring in the third quarter of 2018, even though the starting unemployment rate for the scenario, and the actual unemployment rate, is below 6%.

  - □ Any CCAR/stress testing supervisory scenarios should be transparent and subject to public notice-and-comment rulemaking procedures.

- ■ **Procedural Elements of CCAR**

  - o **Modification of timing and sequence of CCAR and stress testing if supervisory models and qualitative assessments are retained**

    - □ If the Federal Reserve retains its supervisory models, its ability to object to capital plans on the basis of a qualitative assessment and the assumption that firms will continue to take all planned capital actions under stressed conditions, it should modify the timing and sequencing of CCAR steps to allow for capital planning decisions to be made after giving firms sufficient time to properly review and consider the results of the Federal Reserve's review of stress testing results.

    - □ This modification would mitigate the inherent uncertainty and insufficient time to react to the Federal Reserve's feedback and would properly restore to each firm and its board of directors the ability, and sufficient time, to evaluate and decide how to formulate its capital plan and planned capital distributions while taking into account the supervisory feedback.

- Specifically, for each CCAR capital planning cycle:
  - First, each firm should be required to submit the portfolio information required by Form FR Y-14, but not its planned capital actions, to the Federal Reserve by April.
  - Second, the Federal Reserve should provide on a confidential basis to each firm the results of the application of the supervisory models to the firm's portfolio by June.
  - Finally, each firm should be permitted to plan capital actions with full knowledge of its firm-specific results, without being subject to Federal Reserve objection, provided that the firm would be projected to meet its post-stress minimum capital requirements based on its proposed capital actions.

o **Reduction of CCAR/stress testing compliance burden**

- The substantial compliance burden and cost on all firms subject to CCAR and/or stress testing requirements—under which individual firms must submit vast amounts of position-specific information, including in some cases *millions* of data fields, to the Federal Reserve *each year*[21]—should be reduced, including by making the following changes:
- Exclude smaller firms with between $10 billion and $50 billion in total assets from all stress testing requirements.
- Reduce the frequency of CCAR/stress testing to a two-year cycle, subject to voluntary off-cycle submissions in the event that a firm wishes to modify its capital plan due to the occurrence of significant events not considered in its most recent capital plan, e.g., a significant divestiture.

[21] For example, the FR Y-14M reporting forms cover residential real estate positions and include 153 data fields for each position. For a firm with, say, 100,000 residential real estate loans, this results in approximately 15 million data fields in each monthly filing, or nearly 200 million for an entire calendar year for just one product class in just one reporting form in the FR Y-14 series.

  - — There is no statutory requirement for CCAR and not even for supervisory stress tests as opposed to "analyses."[22] These statutorily mandated "annual analyses" could be accomplished through a supervisory review.

- □ Eliminate the DFAST mid-year requirement.
  - — The benefits of a mid-year stress test are negligible, given the year-round stress-testing compliance activities that banking organizations are already subject to under CCAR.

- □ Reduce the number of supervisory scenarios from three to one, eliminating the baseline and adverse scenarios and retaining the severely adverse scenario.
  - — The non-binding baseline and adverse scenarios are purely administrative exercises of negligible supervisory benefit that needlessly consume time, effort and supervisory resources.

Means of Implementation

- Except for the exclusion of $10-$50 billion firms from all stress testing requirements, changes to the requirement to perform semiannual company-run stress tests and changes to reduce the number of supervisory scenarios from three to one, these CCAR/stress testing changes should not require legislative amendments. They can be accomplished by agency action in amending their own regulations, guidance or instructions. If the Federal Reserve is unable or unwilling to conclude that the statutory mandate for annual analyses does not compel either an annual CCAR submission or supervisory stress test, Congressional action to modify the statutory requirements related to supervisory-run CCAR/stress testing accordingly would be necessary.

[22] The relevant provision of the Dodd-Frank Act calls for "annual analyses in which [banking organizations] are subject to evaluation of whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions." 12 U.S.C. § 5365. The only reference to supervisory "stress tests" is in a caption, but there is no such reference in the legislative text relating to supervisory analyses. In contrast, the legislative text relating to company-run stress tests specifically requires stress tests.

2. Capital Requirements

2.1. *Supplementary Leverage Ratio*

Background and Summary of Requirements

- The U.S. Basel III capital rules include minimum and add-on (or buffer) requirements for both risk-based capital ratios and leverage ratios. Risk-based capital ratios apply risk weights ranging from 0% to 1,250% to assets based on their level of risk, requiring that riskier assets be financed with relatively more capital and less debt. In contrast, leverage ratios are not risk sensitive. For example, an unsecured loan to a risky borrower has the same leverage requirements as a secured loan to a highly creditworthy borrower.

- There are two leverage ratios in the United States. The first, the U.S. leverage ratio, is a simple leverage ratio, measured as Tier 1 capital divided by quarterly average on-balance sheet assets. U.S. banking organizations must maintain a minimum 4% U.S. leverage ratio to be adequately capitalized and a 5% U.S. leverage ratio to be considered well capitalized. To satisfy the minimum U.S. leverage ratio requirement, a banking organization must finance every $100 in on-balance sheet assets with $4 of Tier 1 capital.

> "Nothing is free. There are both costs and benefits to regulation. . . . Higher equity capital is more expensive. Those costs are passed along to customers and to shareholders and there will be some potential effect on growth as well." – Jerome H. Powell, Governor, Federal Reserve "[23]
>
> *– Jerome H. Powell, Governor, Federal Reserve*

- The second leverage ratio, the SLR, is part of the U.S. Basel III capital rules and will become effective in 2018. Like the U.S. leverage ratio, the SLR is also risk-insensitive, measuring all exposures identically. Unlike the U.S. leverage ratio, the SLR measures Tier 1 capital against total leverage exposure, a denominator that includes both on-balance sheet assets and certain off-balance sheet exposures. The required SLR is 3% for advanced approaches BHCs that are not G-SIBs and 5% (3% minimum plus 2% buffer) for G-SIBs. IDI subsidiaries of G-SIBs must maintain an SLR of at least 6% to be well-capitalized.

[23] Jerome H. Powell, Governor, Fed. Reserve, Q&A Session at the Global Finance Forum (Apr. 20, 2017).

Problems with Implementation

> "[W]ith the constraints of risk-based capital and liquidity requirements lifted, they would be strongly incentivized to change the composition of their balance sheets dramatically, shedding safer and more liquid assets like Treasuries in exchange for riskier but higher-yielding assets. After all, with a leverage ratio as the only significant constraint, the regulatory cost of holding a short-term Treasury bill is identical to that of a junk bond. It is this very limitation of a leverage ratio that led to the creation of a complementary risk-based capital requirement in the 1980s."[24]
>
> *– Daniel K. Tarullo, Governor, Federal Reserve*

- **Risk-insensitive measure as binding constraint.** The SLR is intended to be a complementary backstop to the risk-based capital ratios, but the public disclosures by advanced approaches BHCs indicate that an SLR-based requirement, e.g., the enhanced SLR requirement applicable on a BAU basis or the post-stress SLR under CCAR, is or will be the binding capital constraint for some BHCs. In addition, the risk-insensitive nature of the SLR is exacerbated by its treatment of items that pose no economic risk of loss as "exposures" against which capital must be held.

- **Excessively conservative U.S. surcharge.** The international Basel III standard for the SLR, known as the Basel III leverage ratio outside the U.S., which applies to G-SIBs in most countries, is 3%, but U.S. regulators have imposed higher SLR requirements on G-SIBs and their IDI subsidiaries. In addition, banking organizations that are subject to the CCAR/stress testing requirements and the resolution planning guidance must meet still higher SLR requirements because the U.S. regulators have incorporated the SLR into those regulatory contexts, which assume stressed conditions (requiring more capital) rather than normal economic conditions.

- **Contradictory rules.** Under the SLR requirements, banking organizations must maintain as much Tier 1 capital against cash on deposit with the Federal Reserve as against an equivalent amount of long-dated corporate loans. Because HQLAs tend to be low-yielding assets, banking organizations are more constrained under the SLR for increasing their holdings of liquidity-enhancing HQLAs.

> "I think we need to look again at the calibration of the leverage ratio United States for the largest institutions. . . . [I]t's time to have that conversation."[25]
>
> *– Jerome H. Powell, Governor, Federal Reserve*

Recommendations

- **Remove excessive calibration (eSLR).** U.S. G-SIBs are subject to a 2% buffer on top of the 3% minimum SLR requirement and their bank subsidiaries are subject to a 6% minimum SLR requirement, both of which represent a much higher calibration than the 3% minimum under the international SLR standard.

[24] Daniel K. Tarullo, Governor, Fed. Reserve, Departing Thoughts (Apr. 4, 2017) (link).

[25] Jerome H. Powell, Governor, Fed. Reserve, Q&A Session at the Global Finance Forum (Apr. 20, 2017).

> "[I]n the normal state of affairs, we really don't want the leverage ratio to be the binding constraint on financial institutions . . . . [I]t can impose excess costs of intermediation of low risk assets. . . . [T]he U.S. enhancement of the leverage ratio on top of the SLR [runs] the risk of doing exactly that."[26]
>
> *– Jerome H. Powell, Governor, Federal Reserve*

> "Risk-insensitive leverage ratios are a blunt regulatory tool that may create perverse incentives for banks to hold relatively riskier portfolios. A recent study by The Clearing House found that "risk-based capital ratios are likely to be a better predictor of bank failure than leverage ratios," since "[b]y design, two banks of the same asset size with the same amount of capital will have the same leverage ratios; but the bank with riskier assets will a have a lower risk-based capital ratio." Moreover, the Bank of England has been critical of binding leverage ratios, stating that "a leverage ratio on its own … might encourage risk-taking by banks since it does not specify that riskier exposures should be funded with more capital than other exposures."[27]
>
> *– Bank of England, Financial Stability Report*

- **Modifications to total leverage exposure (denominator of SLR).** The following changes would better align the liquidity requirements with the principle that the SLR should, like the existing Tier 1 leverage ratio, serve as a complementary backstop to the risk-based capital requirements and avoid overstating total leverage exposure:
  - **Exclusion of cash and cash equivalents.** Exclude from total leverage exposure all cash and cash equivalents, such as cash on deposit with central banks, U.S. Treasuries and government agency securities, and foreign sovereign debt that qualifies for a 0% risk weight under the risk-based capital rules.
    - This exclusion would mitigate the current contradiction between the SLR and liquidity requirements, such as the LCR. It would complement the liquidity requirements by allowing banking organizations to increase their holdings of HQLAs, such as U.S. Treasuries, and consequently to improve the liquidity of the markets for these HQLAs, without being penalized by having to add more Tier 1 capital.
  - **Restoration of U.S. GAAP offset/netting.** For all collateralized transactions, including derivatives and repo-style transactions, allow firms to recognize the full extent of U.S. GAAP netting/offset and collateral, whether initial or variation margin, to the same extent as under the risk-based capital rules, preventing total leverage exposure under the SLR from being overstated compared to U.S. GAAP and/or all other parts of the U.S. capital rules.
  - **Replacement or amendment of CEM.** Replace or amend CEM as the method for calculating the leverage exposure amount of derivatives transactions to avoid overstatement of exposure amounts, as discussed in Chapter 2.

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[26] Jerome H. Powell, Governor, Fed. Reserve, Q&A Session at the Global Finance Forum (Apr. 20, 2017).

[27] BANK OF ENGLAND, FINANCIAL STABILITY REPORT ISSUE NO. 39, 35 (July 2016).

"The Basel leverage ratio has failed to properly consider the exposure-reducing effect of customer margin posted to a prudentially-regulated banking entity that is acting as an agent to facilitate derivatives clearing services on behalf of the client."[28]

– Walt Lukken, CEO, Futures Industry Association

"[N]eedlessly high leverage capital constraints could impair a clearing member's ability to take on new customers or purchase a portfolio of derivatives from a distressed clearing member."[29]

– John Carney, Randy Neugebauer, Frank Lucas and Bill Foster

"[I]f a bank seeks to reduce its capital requirement by lowering its [Method 2] GSIB score, it may become impossible to justify holding any non-operating deposits."[30]

– J.P.Morgan, A Defining Moment: New Regulations and Their Impact on the Definition of Cash Deposits

Means of Implementation

- These changes do not require legislative amendments. They could be accomplished by agency action in amending their own regulations.

2.2. *G-SIB Surcharge*

Background and Summary of Requirements

- The G-SIB surcharge is a firm-specific capital buffer that U.S. G-SIBs must maintain on top of minimum risk-based capital requirements, along with other capital buffers, in order to avoid graduated limitations on capital distributions and discretionary bonus payments to senior managers. The level of the G-SIB surcharge varies by firm, with the current range varying from 1.0% to 3.5%, based on 12 measures of systemic risk. which are organized into categories of size, interconnectedness, complexity, cross-jurisdictional activity, substitutability and use of short-term wholesale funding.

- The U.S. G-SIB surcharge rule has two methodologies, Method 1 and Method 2, for calculating systemic risk scores and the resulting G-SIB surcharges. U.S. G-SIBs are subject to the higher of a Method 1 and Method 2 surcharge. The Method 2 surcharge incorporates a short-term wholesale funding factor, in lieu of a substitutability factor. The Federal Reserve has noted that Method 2 generally results in a higher surcharge than Method 1.

Problems with Implementation

- **Excessively conservative U.S. requirements.** The U.S. implementation of the G-SIB surcharge requirement imposes significantly higher surcharges than the international standard because of the use of Method 2, which includes a measure of short-term

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[28] *Impact of Capital and Margin Requirements on End Users: Hearing Before the H. Subcomm. on Commodity Exchanges, Energy & Credit*, 114th Cong. (Apr. 28, 2016) (statement of Walk Lukken, CEO, Futures Industry Association) (link).

[29] Letter from John Carney, Randy Neugebauer, Frank Lucas & Bill Foster, to Jacob Lew, Secretary, Treasury (Nov. 5, 2015).

[30] J.P.Morgan, A Defining Moment: New Regulations and Their Impact on the Definition of Cash Deposits (2015) (link).

wholesale funding as well as a 2x multiplier compared to Method 1 scores.

- **Overlapping and duplicative rules.** The G-SIB surcharge overlaps with other rules in illogical and redundant ways. For example, the key feature of an institution's Method 2 surcharge score is a measure of reliance on short-term wholesale funding. Reliance on short-term wholesale funding is already addressed by liquidity requirements such as the final LCR and the Federal Reserve's liquidity stress testing rule, which require more liquid assets for repo transactions and other short-term wholesale funding sources compared to longer-term funding sources. Increasing the size of the G-SIB surcharge (which itself is an additional buffer on top of the 2.5% of CET 1 capital conservation buffer) to account for short-term wholesale funding is unnecessarily duplicative.

  In addition, the Federal Reserve may propose adding the G-SIB surcharge to the minimum capital requirements that a G-SIB must satisfy as part of the CCAR/stress testing requirements. Such a change would add yet another capital buffer, on top of the enhanced SLR, to a banking organization's stressed capital requirements, which in turn would require the banking organization to hold even more capital than necessary in normal economic conditions. The rationale of a capital *buffer* should be to allow a banking organization to use that buffer to absorb losses in stressed economic conditions, not to hold so much capital as to make it highly unlikely that the buffer would ever be used.

> "The only effective way for a firm to reduce its G-SIB surcharge is to reduce its market making and other activities that provide market liquidity and generally support capital markets."[31]
>
> *– Greg Baer, President, The Clearing House Association*

Recommendations

- **Elimination or modification of Method 2 surcharge.**
  - Eliminate the Method 2 surcharge to restore a level playing field between U.S. and international Basel III standards.
  - In the alternative, mitigate the magnified effect of Method 2 by:

[31] *Bank Capital and Liquidity Regulation Part II: Industry Perspectives: Hearing Before the S. Committee on Banking, Hous. & Urban Affairs*, 115th Cong. (June 23, 2016) (statement of Greg Baer, President, The Clearing House Association) (link).

      - Eliminating the doubling of Method 2 indicator scores compared to Method 1 indicator scores for purposes of applying G-SIB surcharge level;[32] and

        — Revising the measure of short-term wholesale funding to more appropriately reflect inflows that could offset potential short-term outflows and recognize HQLAs that firms must already hold to cover potential short-term cash outflows under the LCR.

- **Modification of Method 1 surcharge.** Modify Method 1 to eliminate relative scoring and foreign exchange rate volatility and to reflect changes made to total leverage exposure in the SLR:

  - Like Method 2, the modified Method 1 should incorporate the fixed approach for weighting each systemic indicator as part of the overall score, rather than the relative approach used in the existing Method 1.

    - Under the relative approach in Method 1, a G-SIB would receive no credit for reducing its systemic footprint if other G-SIBs have similarly reduced their systemic footprints, i.e., it fails to incentivize a broader reduction in systemic footprints by all G-SIBs.

    - The fixed approach incentivizes U.S. G-SIBs to reduce systemic risk, regardless of the actions taken by other firms.

    - Under the fixed approach, the potential for foreign exchange rate volatility to affect the G-SIB surcharge scores is substantially mitigated, since the constant denominators are converted from euros to dollars only once, using a multi-year average exchange rate.

    - To the extent that total leverage exposure continues to be used as an indicator or part of an indicator in Method 1, i.e., size

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[32] Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49,082, 49,082 n. 5 (Aug. 14, 2015) ("The fact that method 2 likely produced a higher surcharge than method 1 derives from the difference in the calibration of these two methods. To allow comparability between scores produced under method 1 and method 2, method 2 raw scores were doubled.")

indicator, or in Method 2 if Method 2 is still used, this measure should reflect all modifications made to total leverage exposure for purposes of the SLR.

- **G-SIB surcharge as buffer.** Continue to treat the G-SIB surcharge as a buffer requirement, not as part of any minimum capital requirements for any purpose including post-stress minimum requirements for CCAR/stress testing or resolution planning purposes, e.g., RCEN.
    - The G-SIB surcharge was designed and implemented as a buffer, not a minimum requirement.[33] Buffers are *designed* to absorb unexpected losses and should be *permitted* to absorb such losses in times of stress without the organization being deemed to have fallen below its minimum requirements.

Means of Implementation

- These changes do not require legislative amendments. They could be accomplished by agency action in amending their own regulations or, in the case of not adding the G-SIB surcharge to CCAR/stress testing, leaving the CCAR/stress testing rules unchanged. In the case of resolution planning, the agencies can leave their guidance unchanged.

2.3. *Risk-Based Capital Requirements*

Background and Summary of Requirements

- Since the implementation of the first Basel accord in 1992, the primary capital requirements in the United States have been risk-based. Under risk-based capital requirements, assets are weighted according to risk in order to calculate RWAs, the denominator of the risk-based capital ratios, thereby requiring banking organizations to maintain more capital for riskier assets.
- The U.S. Basel III rules recognize two approaches to measuring RWAs for credit risk—the standardized approach and the advanced approaches.

[33] 12 C.F.R. § 217.11 (treating the sum of the 2.5%, an institution's applicable countercyclical capital buffer and its G-SIB surcharge as the level against which the institution's actual capital conservation buffer is compared to avoid payout ratio limitations).

- The standardized approach to calculating RWAs in the U.S. banking agencies' capital rules is not that far removed from the simplistic approach to calculating RWAs under the original Basel capital accord known as Basel I, which was in effect in the United States from 1992 until 2014 for the advanced approaches firms and 2015 for all other firms. It imposes standardized risk weights, developed by the regulatory agencies, to broad, standardized categories of exposures, regardless of maturity and in most cases regardless of seniority of a debt exposure, regardless of industry, geography or risk concentration, and regardless of the banks' own experience with defaults or losses arising from defaults, and gives only limited recognition to netting or collateral in the case of OTC derivatives and collateralized transactions. Under the standardized approach, virtually no internal assessments or models of credit quality and loss experience can be applied.

- The standardized approach incorporates certain off-balance sheet exposures, including the exposure of a banking organization to the risk, called counterparty credit risk, that a counterparty will default on its obligations under an OTC derivative contract at a time when the fair value of the contract is positive from the perspective of the banking organization. The methodology for measuring counterparty credit risk under the standardized approach is called the current exposure method, or CEM.

  - The CEM is incorporated into various capital rules, including the standardized approach for credit risk RWAs, the measurement of total leverage exposure under the SLR requirements and multiple G-SIB surcharge indicators, as well as into proposed rules not directly related to capital, such as the SCCL. Thus, the problems with the CEM are compounded by its appearance in several rules.

  - Under the CEM, the exposure amount for an OTC derivative (or netting set of OTC derivatives) equals the current mark-to-market value of the exposure (to the extent that it is positive) plus an add-on corresponding to the potential future exposure, i.e., the potential for a negative exposure to turn into a positive one, or for a positive exposure to grow. The add-on component includes a simplistic measure of the potential future effect of netting on the exposure amount, which caps the potential future netting at 60% even if the netting arrangement would contractually net the exposure to zero. This approach can give relatively little credit for highly effective hedges that a banking organization would recognize as part of its own credit risk management framework.

- In 2014, the Basel Committee finalized a replacement standard for the CEM known as SA-CCR, which was designed to address certain limitations of the CEM.

- Under the advanced approaches, banking organizations may use internal models to calculate RWAs for credit risk, with prior regulatory approval and subject to oversight and supervision by the primary federal regulator. The advanced approaches for credit risk are generally more risk-sensitive than the standardized approach. Advanced approaches banking organizations must also calculate RWAs for operational risks, which are not required for standardized approach firms.

Problems with Implementation

- **Overly conservative assumptions and failure to recognize valid risk-mitigation of the standardized approach.** The standardized approach reflects overly conservative and unrealistic assumptions and does not recognize, or insufficiently recognizes, valid risk-mitigating techniques. As a result, the amounts and risks of different exposures can be understated or overstated.

> "Regulations requiring banks to hold more capital and more restrictive constraints on leverage have increased the cost of securities financing activities and reduced incentives to maintain them."[34]
>
> *– Office of Financial Research, 2014 Annual Report*

Recommendations

- **Rationalize the standardized approach for calculating RWAs for credit risk through an open, transparent process.** The banking agencies should reassess the standardized approach for credit risk, seeking public comment on exposures for which the standardized approach reflects illogical and overly conservative assumptions. In particular, the banking agencies should reassess the standardized approach's methods for recognizing credit-risk mitigation techniques such as collateral and netting arrangements, including the following examples:
  - **Rationalize the standardized approach's provisions for calculating exposure amount of derivatives.** The CEM should be replaced or, in the alternative, modified as follows:

[34] OFFICE OF FINANCIAL RESEARCH, 2014 ANNUAL REPORT (Dec. 1, 2014) (link).

  - SIFMA generally supports SA-CCR, the new approach finalized by the Basel Committee, as a non-internal models-based replacement for the CEM, provided that certain shortcomings in SA-CCR are addressed in its U.S. implementation.

  - If the banking agencies fail to adopt a modified SA-CCR that addresses its shortcomings as a non-internal models-based alternative measure of standardized RWAs for derivatives exposures, in the alternative the CEM should be modified to better reflect economic realities, such as by removing its 60% cap on the recognition of netting arrangements.

- **Rationalize the standardized approach provisions for collateralized transactions and recognition of collateral and netting.** Amend the collateral haircut approach for collateralized derivatives, repo-style transactions and eligible margin loans to make it more risk sensitive and better aligned with economic reality, including by permitting banking organizations to use their own internal collateral haircuts instead of the supervisory haircuts[35] and recognize the benefits of collateral diversification and non-correlated collateral.

- **Permit a continued role for the advanced approaches for calculating RWAs for credit risk.** The banking agencies should continue to permit advanced approaches banking organizations to use appropriately supervised internal models to calculate advanced approaches RWAs for credit risk.

  - The advanced approaches are more risk sensitive than the standardized approach, considering more granular differences in credit quality between exposures. Therefore, the advanced approaches result in credit risk RWAs that are more closely aligned to the actual risks of each exposure, resulting in better alignment of costs and risks and more accurate pricing of credit.

[35] Under the current U.S. Basel III capital rules, a banking organization is permitted to use its own internal estimates for haircuts only with the prior approval of the relevant banking agency. 12 C.F.R. § 217.37(c)(4).

- For banking organizations that choose to invest in developing and maintaining approved internal models, these more risk-sensitive approaches should be retained.

- **Amend capital adjustment and deduction provisions (affecting the numerator of capital ratios).** The following changes to the numerator of regulatory capital ratios should be made to all measures in which regulatory capital is included as a component, including but not limited to U.S. Basel III rules' risk-based capital ratios, the U.S. leverage ratio, the SLR, and the Federal Reserve's TLAC requirements:

  - The AOCI filter should be adjusted to exclude unrealized gains and losses on available-for-sale securities that qualify as HQLA or all banking organizations should be permitted to opt out of AOCI adjustments for such securities.

    — This change would reduce volatility in the amounts of CET 1 and Tier 1 capital and would avoid working at cross-purposes with the liquidity requirements, which are intended to incentivize firms to increase their holdings of HQLAs, which are primarily AFS debt securities. Currently the effect of increasing holdings of AFS debt securities is to increase swings in CET 1 and Tier 1 capital as a result of the recognition of unrealized gains and losses.

> "[B]ecause of regulation in the banking industry, many of these banks used to carry inventory and make markets, and that's no longer the case. You had much faster pricing, you had more transparency. A lot of that is gone now . . . . [I]f there's ever a major run on credit funds . . . who's going to buy this debt?"[36]
>
> *– Henry Kravis, CEO, Kohlberg Kravis Roberts & Co.*

  - Include a market-making exemption, in addition to the underwriting exemption, for significant and non-significant investments in the capital of unconsolidated financial institutions.

    — This change would complement the current underwriting exemption and recognize that market-making activities, like underwriting activities, are not intended to reflect strategic or long-term investments in the capital of other financial institutions, but to facilitate their liquidity and thus facilitate the ability of financial institutions to raise more capital.

[36] Henry Kravis, CEO, Kohlberg Kravis Roberts & Co., Worry About What You Might Lose on the Downside (June 13, 2016) (link).

- Narrow the definition of financial institution to exclude (1) funds that would otherwise fall within the definition of "investment fund" for purposes of the equity exposure provisions and (2) joint venture vehicles.
  - Investments in funds are already subject to a separate risk weighting framework under the U.S. Basel III capital rules. This change is intended to eliminate duplicative and inconsistent treatment between investment funds that would also be captured by the definition of financial institution.
  - Joint ventures investments held through an investment company should not be viewed as a source of contagion risk.

Means of Implementation

- These changes would not require legislative amendments and could be accomplished by agency action in amending their own regulations.

2.4. *Other Recommendations*

- **Supervisory actions should not be used to implement RWA floors or other *de facto* capital requirements without public notice and comment.**
  - The banking agencies should not use the non-transparent supervisory process to create additional capital requirements, such as implementing floors on operational risk RWAs under the advanced approaches, floors on expected credit loss parameters, i.e., probability of default and loss-given-default, used under the advanced approaches for credit risk, or other limitations on internal models. Any such *de facto* changes to the capital rules should be implemented through the public notice-and-comment rulemaking process.
- **Delay implementation of major new capital standards of the Basel Committee**
  - The banking agencies should carefully consider the implications on U.S. credit intermediation and systemic risk from the implementation in the United States of a revised standardized

approach for credit risk under the Basel III capital framework,[37] if and when finalized by the Basel Committee.

- The Basel Committee's Fundamental Review of the Trading Book standard would, among other changes, replace the value-at-risk-based approach used in the existing market risk capital rule with an approach based on a new internally modeled measure called expected shortfall and on a revised standardized measure that could operate as a floor to the internal models-based measure.

- As proposed by the Basel Committee, the Fundamental Review of the Trading Book standard is excessively overcalibrated, and particular elements should be studied and modified before being implemented in the United States.

  - A 2016 study jointly conducted by ISDA, GFMA and IIF concluded that the proposed standardized approach methodology under the Fundamental Review of the Trading Book would result in between 1.5 and 2.4 times the total market risk capital requirement that firms are required to maintain today. The study found that the significant drivers of this excess calibration were uncertainty around approvals for the use of internal models and cliff effects between standardized and internal model calibrations. For some product types, such as foreign exchange and equity markets, these cliff effects are particularly pronounced, with a loss of internal model approval resulting in increases in capital requirements of between 4.1 times and 6.2 times.[38]

2.5. *Means of Implementation*

These recommendations would not require legislative amendments and could be accomplished by agency action in amending their own regulations, curtailing regulatory overreach through supervisory actions and seeking public comment on future changes to the capital rules.

[37] Such a revised standardized approach for credit risk, plus other contemplated changes to the Basel III capital framework, are sometimes referred to as Basel IV.

[38] ISDA, *FRTB: One Piece of the Capital Puzzle* (Apr. 21, 2016) (link).

Chapter 3

LIQUIDITY AND FUNDING REQUIREMENTS

Relevant Agencies

- FRB
- FDIC
- OCC

Chapter 3 – Liquidity and Funding Requirements

Banking organizations, depending on their size, are now subject to multiple new liquidity requirements. These requirements are complex and duplicative, are generally based on one-size-fits-all assumptions of regulators rather than actual market liquidity and in many respects are calibrated above international standards. They systematically overestimate the run risk of liabilities and underestimate the liquidity of asset classes, especially private-sector debt and equities. As a result, each banking organization's balance sheet increasingly reflects the quantities and types of liquid assets prescribed by regulatory models instead of reflecting its particular liquidity needs.

A. Original Problem to be Remedied

As discussed in Chapter 3, there have been significant improvements to the resiliency of banking organizations through the adoption of liquidity requirements designed to improve banking organizations' ability to withstand stressed conditions both in the short term, e.g., the LCR and liquidity stress testing requirements, and the longer term, e.g., the Federal Reserve's TLAC rule and liquidity stress testing requirements. As a result, not only are banking organizations better capitalized than before, as discussed in Chapter 2, but they also benefit from having more liquid balance sheets.

B. Need for Rebalancing

Certain aspects of the liquidity requirements, however, run contrary to their original intent—to promote financial stability—and contrary to several of the Core Principles.

- **Potentially market destabilizing impact.** While the original intent of the post-crisis liquidity requirements was to promote financial safety and soundness, certain aspects of these requirements have the potential to achieve the opposite result. Liquidity regulations such as the LCR and the proposed NSFR, taken together with certain aspects of the capital requirements discussed in Chapter 2, promote certain business lines and types of funding over others, in particular the holding of public debt over private debt, as discussed in Chapter 9. Diversification of funding sources across the U.S. banking sector is therefore at risk, increasing vulnerability of the financial system to liquidity stress. These increased risks work against Core Principles (b) (preventing taxpayer-funded bailouts), (c) (economic growth and vibrant financial markets) and (f) (efficient, effective and appropriately tailored regulation).

> "With regulation tighter, it may well be harder for market-makers to absorb inventory when end investors wish to off-load assets; market liquidity may start to fall away at an earlier point. The risk of another complete failure of market liquidity should be much reduced. But market participants will not always be able to sell what they want, where they want and when they want."[1]
>
> *– Sir Jon Cunliffe, Deputy Governor for Financial Stability of the Bank of England*

- **Calibrations of liquidity requirements do not reflect true liquidity characteristics**. Regulatory risk calibrations are often more conservative than actual historical experience during the financial crisis and do not reflect the true liquidity risk of transactions. The regulations lack a mechanism to account for the dynamic nature of actual markets. For example, the current top three most heavily traded stocks on the NASDAQ are not considered liquid under the LCR or the proposed NSFR. The one-way ratchet toward higher amounts of liquidity ignores the costs on lending, market liquidity and other contributors to banking and capital markets activities and economic growth.[2] Some studies have found that liquidity requirements under the LCR lead to a decline in lending volume in the range of 2% to 5% and a decline in GDP in the range of 3 to 100 basis points. These outcomes work against Core Principle (c) (economic growth and vibrant financial markets).

- **More stringent U.S. requirements than international standards.** Liquidity requirements have been calibrated at excessively conservative levels by U.S. regulators compared to international standards, working against Core Principles (d) (enabling American competitiveness) and (f) (efficient, effective and appropriately tailored regulation). The U.S. liquidity requirements systematically reflect more conservative and less risk-sensitive assumptions than the Basel Committee's international standards and require U.S. banking organizations to hold more liquidity than their non-U.S. counterparts that are subject to non-U.S. rules more closely aligned with the international standards. Deviations from international standards may be appropriate in certain instances, but the U.S. banking agencies generally have not performed a proper quantitative analysis showing the need for these deviations or a proper

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[1] Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England, The role of the leverage ratio and the need to monitor risks outside the regulated banking sector (July 17, 2014) (link).

[2] Olivier de Bandt & Mohammed Chahad, *A DSGE model to assess the post crisis regulation of universal banks* (Nov. 12, 2015) (link); Francisco Covas & John C. Driscoll, *Bank Liquidity and Capital Regulation in General Equilibrium* (Sept. 12, 2014) (link).

cost-benefit analysis evaluating their effect on banking and capital markets activities and economic growth.

- **Overlapping, duplicative and contradictory rules.** Complex, overlapping and duplicative rules have produced cumulative and excessively high requirements as well as contradictory incentives, working against Core Principles (c) (economic growth and vibrant financial markets), (f) (efficient, effective and appropriately tailored regulation) and (g) (restoration of public accountability within, and rationalization of, federal financial regulatory framework).
  - In the one-size-fits-all liquidity model imposed by the LCR, the limited pool of instruments qualifying as HQLAs leads to increased concentration and correlation risk and embeds a regulatory preference for public-sector debt over private-sector instruments that can contribute to economic growth.
  - Liquidity requirements can work at cross-purposes with capital requirements, creating counterproductive incentives for some banking organizations to curtail lending. For example, a bank that holds increased amounts of HQLAs, such as U.S. Treasuries, in order to comply with the LCR must also hold a corresponding increased amount of Tier 1 capital to comply with the Tier 1 leverage ratio and the SLR. As a result, instead of providing an incentive for banking organizations merely to add more HQLAs to their existing exposures, the liquidity requirements, acting in combination with risk-insensitive leverage capital requirements, create an incentive for banking organizations to reduce their holdings of non-HQLA exposures to compensate for more HQLAs in order not to be penalized by the capital requirements. Banking organizations are incentivized to reduce holdings of loans, private-sector corporate debt and equities—asset classes that contribute to private-sector economic growth and typically yield higher returns in exchange for higher risks—in favor of government and government agency debt, asset classes that represent public-sector financing with low returns and low risk. The effect is for banking organizations to reduce their role in taking the risks inherent in engaging in banking and capital markets activities, i.e., credit intermediation, maturity transformation and market making, as discussed in Chapter 9.

> "Banks' demand for high quality liquid assets (HQLA) such as sovereign debt will increase as a result of the LCR. By all accounts, in a market stress, banks can be expected to hoard HQLA, for fear of regulatory or market sanction if they are perceived as losing liquidity. Bank demand for these assets will also compete with money market funds, which typically hold Treasuries and sovereign debt to satisfy statutory requirements to maintain minimum levels of overnight and weekly liquidity."[3]
>
> *– PricewaterhouseCoopers LLP*

[3] PricewaterhouseCoopers LLP, *Global financial markets liquidity study* (Aug. 2015) (link).

C. Proposed Recommendations

1. Liquidity Coverage Ratio

Background and Summary of Requirements

- As part of the Basel III liquidity framework, the LCR requires a banking organization to maintain an amount of HQLAs at least equal to its net cash outflows over a 30-day standardized stress scenario. The U.S. LCR rule defines which instruments constitute HQLAs, but does so more stringently than the international Basel LCR standard. HQLAs are divided into two levels, with Level 2 assets subject to prescribed haircuts and a quantitative cap to ensure that the majority of a banking organization's HQLAs consist of Level 1 assets. The U.S. LCR rule also requires each banking organization to use standardized cash inflow and outflow rates, scaled from 0% to 100%, to calculate its total net cash outflows over the stress period. The prescribed methodology for calculating total net cash outflows includes a cap on cash inflows at 75% of cash outflows and an add-on calculation to address potential maturity mismatches between outflows and inflows.

Problems

- **Risk-insensitive and excessively conservative requirements**

  - Banking organizations are subject to a one-size-fits-all stressed liquidity model imposed by the banking agencies, with HQLA eligibility requirements and inflow and outflow assumptions that are all prescribed and standardized without regard to banking organizations' own client base, business model, balance sheet composition or liquidity experience. This one-size-fits-all approach is in contrast to the Federal Reserve's liquidity stress testing requirements in its Regulation YY, which are based on banking organizations' own models and assessments and thus are more appropriately tailored.

  - The LCR is a fairly unsophisticated and risk-insensitive measure. For example, liquid assets that could be monetized even under stressed conditions are not recognized as HQLAs and are unrealistically given zero value for purposes of the liquidity requirements. Similarly, the inflow and outflow rates are subject to excessively conservative and asymmetrical assumptions, which means that the denominator of the LCR, net cash outflow, is deliberately overstated. For example, a banking organization cannot assume inflows from drawing down on certain of its credit and liquidity facilities, but on the other hand must assume that its counterparties will draw down the full undrawn amount of any such credit and liquidity facilities. The LCR is also calibrated to produce, in all cases, a liquidity buffer of at least 25% compared to net cash outflows, as cash inflows are arbitrarily capped at 75% of cash outflows.

- The U.S. banking agencies have imposed an excessively conservative version of the LCR compared to the international standard, including by:
  - Limiting or excluding from eligibility as HQLAs such assets as securities issued or guaranteed by public-sector entities below the sovereign level, such as municipalities, covered bonds issued by financial institutions, and RMBS, and by severely limiting the inclusion of corporate debt securities in HQLAs; and
  - Instead of using the cumulative net cash outflow amount for the 30-day assumed stress period, adding a complicated maturity mismatch add-on component based on the difference between the net cumulative peak day maturity outflow—that is, the largest daily difference in cumulative outflows and inflows—and the net cumulative maturity outflow on the 30th day of the assumed stress period.
- As a result, compared to the international LCR standard, the U.S. numerator (HQLAs) has narrower eligibility requirements and the U.S. denominator (net cash outflow) adds a maturity mismatch measure, likely increasing the net cash outflow.

- **Overlapping and duplicative rules**
  - The larger U.S. banking organizations are subject to multiple liquidity requirements including the LCR, the Federal Reserve's liquidity stress testing requirements under Regulation YY, stressed liquidity requirements under CLAR, and a different set of stressed liquidity requirements for resolution planning (RLAP and RLEN). All of these requirements overlap to some degree with the LCR. Method 2 of the G-SIB surcharge, which is intended to

measure reliance on short-term wholesale funding as an indicator for capital requirements, uses metrics similar to the LCR, thus converting a liquidity measure into an additional capital requirement.

Recommendations

- **Expansion of instruments qualifying as HQLAs (numerator of LCR).** This change would help to mitigate the concentration and correlation risk that results from a more limited pool of HQLAs. Expanding HQLAs would encourage greater diversification of liquidity sources and lead to improved dealer inventory, which would contribute to greater market liquidity. Including additional private-sector instruments as HQLAs would also support economic growth and help to counterbalance the regulatory preference for public-sector debt embedded in the LCR rule and other liquidity requirements.
  - At a minimum, the LCR rule should permit the same HQLA eligibility requirements as the international Basel LCR standard, including, e.g., residential mortgage-backed securities, to help level the playing field between the U.S. and the Basel LCR, as discussed in Chapter 9.
  - Include securities issued by, or guaranteed as to the timely payment of principal and interest by, Fannie Mae and Freddie Mac as Level 1 HQLAs, at least as long as those entities remain in conservatorship and receive funding commitments from the U.S. Department of the Treasury.
  - Include all types of municipal securities as Level 2B HQLAs so long as they are liquid and readily marketable and investment grade, as proposed in the bill recently introduced by Senators Warner and Rounds.
  - Permit an instrument that is disqualified from HQLAs due to a market price decline criterion to be re-qualified as an HQLA, such as through a sunset period or an assessment of relative liquidity, such as a trading volume standard, that actually reflects the asset's liquidity value. This change would avoid permanent disqualification of, e.g., the current top three most heavily traded stocks on the Nasdaq due to a past market price decrease.

- Revise the definition of "liquid and readily marketable" to incorporate a straightforward, presumptions-based approach, to be supplemented by additional analysis for only a limited pool of securities for which there is truly a question as to whether such securities have the requisite liquidity profile to be eligible HQLAs.

- **Alignment of calculation of net cash outflow (denominator of LCR) with international Basel LCR.** The calculation of net cash outflow should be aligned with the international Basel LCR to level the playing field between the U.S. LCR and the international Basel standard, including by:

  - Eliminating the maturity mismatch add-on component of the LCR calculation and instead using cumulative net cash outflow amounts over the 30-day assumed stress period to address maturity mismatches; and

  - Allowing net cash outflow to be calculated on the final business day of every month instead of daily.

- **Modification of certain excessively conservative and unrealistic cash outflow rates and assumptions.** These changes would appropriately recognize banking organizations' historical experience with the actual performance and stability of categories of liquidity sources, represented by inflow rates, and liabilities, represented by outflow rates, in stressed market conditions and would incentivize prudent diversification of funding sources.

  - Broaden the category of operational deposits to include prime brokerage deposits and deposits provided in connection with operational services to non-regulated funds.

    - This change would recognize that non-regulated funds such as private equity and venture capital funds need operational services such as custody in the same way as regulated funds.

  - Reduce the outflow rates for operational deposits, including excess operational deposits, partially insured retail deposits, retail deposits covered by non-U.S. deposit insurance schemes, categories of brokered deposits that have similar liquidity characteristics to stable retail deposits, and deposits of financial institutions to be more aligned with historical experience.

  - Reduce the outflow rates for a banking organization's debt securities for which it is the primary market-maker to better reflect the liquidity and seniority of such securities.
  - Treat the undrawn portion of multi-purpose commitments as a credit facility rather than a liquidity facility.
  - Eliminate or improve the excessively conservative and asymmetrical outflow and inflow assumptions for credit and liquidity facilities, under which the inflow rate for any committed credit or liquidity facility is 0% and outflow rates range from 0% to 100%.
  - Eliminate or improve the excessively conservative and asymmetrical maturity option assumptions under which, for example, a counterparty is always assumed to opt to reduce an instrument's maturity for purposes of outflow calculations.

- **Elimination of the requirements for public LCR disclosures, which must be made starting in August 2017, or, in the alternative, postponement of the requirements and reassessment and alignment with the SEC's review of Guide 3.**
  - Eliminate the requirement for public disclosure of LCR information. Such granular disclosure could exacerbate potential liquidity stress for a firm and the overall market and could constrain the ability of banking organizations to respond to stressed market conditions.
  - In the alternative, pending consideration of the recommended changes to the U.S. LCR rule, the required public disclosures of the LCR and its components, which are scheduled to be made starting in August 2017, should be postponed to avoid premature disclosures of aspects of the LCR that should be changed.
  - In any event, reassess the granularity of the required LCR disclosures and harmonize them with the SEC's ongoing review of banking organizations' Guide 3 disclosure requirements, which will not be completed until well after August 2017.
    - Banking organizations should not be subject to two different and overlapping U.S. disclosure requirements for liquidity—one mandated by the SEC, which is supposed to reflect current trends and historical market conditions, and one by the Federal

Reserve, which is based on supervisory assessments of funding sources and needs in hypothetical stressed conditions. Any inconsistencies between the two requirements will confuse banking organizations' shareholders, customers and counterparties, as they will be unclear how to reconcile inconsistent disclosures.

- The granularity of the LCR disclosures should be reassessed to avoid the confusion that would arise from requiring banking organizations to make disclosures about supervisory assessments of their liquidity sources and needs in hypothetical stressed conditions, which is what the LCR requirement is designed to model. Shareholders, customers and counterparties would inevitably be confused by, for example, LCR disclosures showing no inflows from credit or liquidity facilities compared to the disclosure of sources of liquidity in SEC reporting and offering documents. In addition, banking organizations that provide operational services to unregulated funds would be adversely affected by disclosures showing lower amounts of operational deposits than banking organizations that have the same amount of deposits related to operational services for regulated funds and other customers. This confusion could lead a banking organization's shareholders, customers and counterparties to make erroneous assessments of its liquidity position, which could lead to a loss of market confidence in and adversely affect that banking organization and U.S. financial stability.
    - Consider rebalancing the liquidity disclosure requirements to reflect a higher level of a banking organization's LCR data, e.g., aggregate HQLA, aggregate inflows and outflows, to avoid misleading and erroneous comparisons between banking organizations' liquidity positions.

Means of Implementation

- These changes would not require legislative amendments and could be accomplished by agency action in amending their own regulations.

2. Proposed Net Stable Funding Ratio

Background and Summary of Requirements

- The NSFR, another component of the Basel III liquidity framework, requires banking organizations to maintain a stable funding profile in relation to their assets and off-balance sheet activities over a one-year, non-stressed time period. The Federal Reserve, OCC, and FDIC issued a proposed rule in 2016 to implement the NSFR in the U.S. The NSFR proposal requires a banking organization to maintain an available stable funding, or ASF, at least equal to its amount of required stable funding, or RSF. The proposed NSFR rule requires each banking organization that is subject to the rule to use standardized ASF factors, scaled from 0% to 100% (least stable to most stable), to its equity and liabilities to reflect their expected stability over a one-year time horizon; these factors are based on funding type, maturity and counterparty type. Each banking organization is also required to use standardized RSF factors, scaled from 0% to 100% (most liquid to least liquid), to defined categories of assets and commitments to reflect their liquidity over a one-year time horizon; these factors are based on credit quality, maturity, type of counterparty, market characteristics and encumbrance. The proposal mandates a separate methodology for calculating RSF factors for derivative transactions.

Problems

- **Not based on asset-liability management principles**
    - The proposed NSFR rule is not based on an asset-liability management framework. Instead, it requires firms to consider assets and liabilities in isolation, measuring each side of the balance sheet against standardized stability factors, with the hope that ASF will exceed RSF. No banking organization would actually manage its assets and liabilities in this manner, given the interdependence between specific assets and liabilities.
- **Poorly designed for a capital markets-centric economy**
    - One of the key strengths of the U.S. economy is its deep and liquid capital markets; capital markets play a far greater role in financing U.S. businesses than do capital markets in Europe and elsewhere.

The proposed NSFR rule, however, imposes heavy penalties on firms that hold inventories of corporate debt and equity securities, while providing no recognition of the funding value of liabilities from related client-facing transactions. This treatment, in addition to ignoring basic asset-liability management principles, would also force firms to retrench from market-making and client facilitation, weakening their contribution to market liquidity in favor of their own liquidity.

> "Costly funding requirements under the Proposed NSFR are likely to be passed on to end-users or may force banks to exit such business lines altogether, thereby decreasing liquidity and affecting end-users' access to credit and the ability to hedge and execute transactions in the capital markets."[4]
>
> *– Coalition for Derivatives End-Users*

- **Poorly designed to support liquidity management practices**
  - The proposed NSFR rule also imposes illogical penalties on liquidity management practices. U.S. Treasury securities, but not central bank deposits, would be subject to funding charges, eroding the cash-like status of U.S. Treasury securities. Firms that place cash balances at other banks would be subject to even higher funding charges, even if such cash placements are necessary to support basic clearing and settlement activities, i.e., operational deposits.
- **Duplicative of TLAC requirements**
  - The Federal Reserve's TLAC rule requires firms to issue minimum amounts of long-dated unsecured debt. While TLAC is primarily a resolution planning tool, it has the effect of extending large banks' liability maturities, resulting in more stable funding. As a result, the TLAC rule and its long-term debt requirement largely achieve the stated policy goal of the proposed NSFR rule while avoiding the NSFR's excessive complexity.
- **Risk-insensitive and excessively conservative requirements**
  - Banking organizations are subject to a one-size-fits-all model imposed by the banking agencies, with assumptions that are all prescribed and standardized without regard to banking organizations' own client base, business model, balance sheet composition or funding/liquidity experience. This is in contrast to the Federal Reserve's liquidity stress testing requirements in its Regulation YY (enhanced prudential standards), which are based on

[4] Coalition for Derivatives End-Users, Comment Letter on the Net Stable Funding Ratio Proposal (Aug. 5, 2016) (link).

banking organizations' own models and assessments and thus are more appropriately tailored.

- Certain assumptions from the stressed LCR scenario are imported into the non-stressed NSFR context with no modification.

- **Lack of robust cost-benefit analysis**
  - The process used by the Basel Committee to develop the NSFR rule and the U.S. banking agencies to propose the NSFR in the United States was not transparent and was not based on any proper cost-benefit analysis.
    - Major components of the final Basel framework, including netting criteria and an add-on measured against gross derivatives liabilities, were never included in consultative papers made available for public comment. After the Basel Committee completed its work in secret, the U.S. banking agencies proposed a rule that follows the same standards, even though the public has never had a meaningful opportunity to comment.
    - The U.S. banking agencies asserted in their May 2016 NSFR rulemaking that adopting the NSFR in the United States would require only $39 billion of incremental funding at U.S. firms,[5] but that figure has never been substantiated with public data and is wildly inconsistent with the European Union's estimate of the shortfall among European firms.

> "[C]ertain aspects of the NSFR are inconsistent with other components of the global financial market reform efforts and will significantly impede the ability of Financial End-Users such as Life Insurers, Pension Plans, and other Asset Managers, to prudently and cost effectively manage their investment portfolios. Ultimately, the increased costs associated with Life Insurers' hedging activity may impact the pricing of products and consumers."[6]
>
> *– American Council of Life Insurers*

Recommendations

- **Withdrawal of proposed NSFR rule.** The proposed NSFR rule should be withdrawn and not finalized. The costs and burdens of the proposed rule far outweigh its benefits, especially in light of the fact that banking organizations are already subject to the LCR, the Federal Reserve's liquidity stress-testing requirements under Regulation YY, and the

[5] Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 81 Fed. Reg. 35124 (June 1, 2016) (link).

[6] American Council of Life Insurers, Comment Letter on Net Stable Funding Ratio Proposal (Aug. 5, 2016) (link).

Federal Reserve's TLAC requirement, which includes a long-term debt component.

- A 2010 Basel Committee study that measured the long-term net benefits of capital and liquidity regulations in terms of the expected yearly output gain associated with the reduced frequency and severity of banking crises found that, at the levels of bank capitalization that currently exist in the United States and assuming a moderate permanent effect from a banking crisis, the net benefit of the NSFR is less than with no NSFR.[7] A 2016 study by The Clearing House concluded that, because the NSFR has no clear, defining objective, it is impossible to measure the NSFR's potential benefits and to assess whether its likely and identifiable costs are outweighed by any such benefits.[8]

- The federal banking agencies did not conduct a proper quantitative impact study or cost benefit analysis of the impact of the adoption of the NSFR. It is not clear how the agencies derived their $39 billion shortfall estimate since the information submitted in prior data submission exercises did not include many features unique to the proposed NSFR rule.

■ **In the alternative, modification and reproposal subject to public notice and comment.** If the proposed rule is not withdrawn, it should be modified and reproposed.

- Any such reproposal should be delayed until after the Basel Committee has finalized any changes to or calibration of the international NSFR standard.

- In any event, separate and apart from any changes the Basel Committee may still make to the international NSFR standard, any U.S. reproposal should make specific changes necessary to mitigate flawed, excessively conservative and unrealistic features of the

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[7] BASEL COMM. ON BANKING SUPERVISIONS, AN ASSESSMENT OF THE LONG-TERM ECONOMIC IMPACT OF STRONGER CAPITAL AND LIQUIDITY REQUIREMENTS (Aug. 2010) (link); eighteen53 Blog, The Clearing House, *Foundational Basel Committee Study Estimates the Costs of NSFR Exceeds its Benefits by Nearly $1 Trillion* (March 27, 2017) (link).

[8] THE CLEARING HOUSE, THE NET STABLE FUNDING RATIO: NEITHER NECESSARY NOR HARMLESS (July 2016) (link).

proposed NSFR rule to make it more appropriate for the U.S. market, just as the European Commission is tailoring aspects of the NSFR in its draft legislation to implement the NSFR in the European Union. The European Union has acknowledged the NSFR's weaknesses by incorporating, in its 2016 draft implementation, dozens of deviations from the Basel Committee's NSFR, including with respect to the ability of high-quality variation margin to reduce derivatives asset amounts and reduced funding requirements for high-quality assets, such as sovereign debt.

- Any U.S. reproposal should include the following changes, which are designed to recognize the beneficial impact of collateral on funding requirements and appropriately reflect banking organizations' historical experience with the actual stability of certain categories of funding sources, represented by ASF factors, and liabilities, represented by RSF factors.
  - Treatment of derivative transactions.
    - Improve ability of variation margin to reduce or offset derivatives asset amounts.
    - Eliminate the 20% add-on for potential portfolio valuation changes.
  - **Interdependent assets and liabilities framework.** Treat certain transactions as linked transactions that create interdependent assets and liabilities, including reusable initial margin received from counterparties and proceeds received from clients' short sales of securities.
  - **Amendments to available stable funding (ASF) factors, numerator of the NSFR**
    - Increase ASF factors of certain retail brokered deposits, brokered transaction deposits, brokered sweep deposits from unaffiliated institutions, non-maturity brokered deposits and non-deposit liabilities owed to retail

> "The effect of banks increasingly hoarding HQLAs is likely to further depress activity in repo markets and markets for collateralised instruments as sovereign debt is commonly used as collateral in such transactions. A study by Anderson and Joeveer (2014) suggests that although there is no shortage of potential collateral, the unwillingness of banks to make assets available for re-use, or contractual and regulatory restrictions on re-use, could form bottlenecks within the system where available collateral is immobilised and unattainable by creditworthy borrowers."[9]
>
> *– PricewaterhouseCoopers LLP*

[9] PricewaterhouseCoopers LLP, *Global financial markets liquidity study* (Aug. 2015) (link).

counterparties to reflect the fact that they behave similarly to retail or non-brokered deposit equivalents.

— Align the treatment of operational deposits more closely with their favorable treatment under the LCR and broaden the category of operational deposits to include prime brokerage deposits and deposits provided in connection with operational services to non-regulated funds, as discussed in the LCR section.

□ **Amendments to required stable funding (RSF) factors, denominator of the NSFR**

— Eliminate or reduce RSF factors for securities held as hedges on client-facing derivatives where clients have provided funding to the banking organization supporting the related hedge and for cash collateral provided to securities lenders in connection with borrowing securities to cover clients' short positions.

— Reduce RSF factors of certain trade date receivables in line with the international Basel NSFR standard to level the playing field between the U.S. NSFR and the international standard, segregated client assets because they do not require any long-term funding obligations, commodities traded on non-U.S. exchanges to align with the treatment of commodities traded on U.S. exchanges, and equities that have highly liquid trading markets.

— Align treatment of collateral received to secure commitments with the treatment of collateral under the LCR.

□ **Eliminate or improve the excessively conservative and asymmetrical maturity option assumptions** under which, for example, a counterparty is always assumed to opt to reduce the maturity of a liability and to extend the maturity of an asset.

■ **Elimination of the requirement for public NSFR disclosures or, in the alternative, reassessment and alignment with the SEC's review of Guide 3.**

- Eliminate the requirement for public disclosure of NSFR information. Peer-to-peer comparisons using such granular data could draw attention to divergent funding strategies and lead to pressure for banking organizations to maintain similar funding profiles, even if their actual funding needs differ, which would in turn increase correlation and concentration risk.

- In the alternative, in order to take into account the foregoing recommendations, reassess the proposed NSFR disclosures, including their granularity, and harmonize them with the SEC's ongoing review of banking organizations' Guide 3 disclosure requirements.

    - Banking organizations should not be subject to two different and overlapping U.S. disclosure requirements for liquidity—one mandated by the SEC, which is supposed to reflect current trends and historical market conditions, and one by the Federal Reserve, which is based on supervisory assumptions of funding sources and needs. Any inconsistencies between the two requirements will confuse banking organizations' shareholders, customers and counterparties, as they will be unclear how to reconcile inconsistent disclosures.

    - The granularity of the NSFR disclosures should be reassessed to avoid the confusion that would arise from requiring banking organizations to make disclosures about their liquidity positions based on supervisory assessments of their liquidity sources and needs, which is what the NSFR requirement is designed to model. This confusion could lead a banking organization's shareholders, customers and counterparties to make erroneous assessments of its liquidity position, which could lead to a loss of market confidence in and adversely affect that banking organization and U.S. financial stability.

        - Consider rebalancing the liquidity disclosure requirements to reflect a higher level of a banking organization's NSFR data, e.g., aggregate ASF and RSF amounts, to avoid misleading and erroneous comparisons between banking organizations' liquidity positions.

Means of Implementation

- These changes would not require legislative amendments. They could be accomplished by agency action in withdrawing the proposed rule and, if they determined to do so, issuing a reproposed rule for public notice and comment.

3. Resolution Adequacy and Positioning (RLAP) and Resolution Liquidity Execution Need (RLEN)

Background and Summary of Requirements

- Resolution planning guidance from the Federal Reserve and the FDIC imposes two new liquidity requirements, known as RLAP and RLEN, on the U.S. G-SIBs and certain non-U.S. banking organizations. RLAP is the amount of liquidity needed to cover the aggregate liquidity net outflows across the firm's material entities under a 30-day scenario that incorporates the firm's internal stress test assumptions and takes inter-affiliate frictions into account. RLEN is the amount of liquidity that would be needed after the parent's bankruptcy filing to stabilize the surviving material entities and fund them during the entire resolution period. As part of its resolution plan, each U.S. G-SIB and certain non-U.S. banking organizations with a single point of entry resolution strategy must model RLAP and RLEN and is expected to maintain sufficient liquidity to satisfy these requirements.

Problems

- Overlap with other liquidity requirements, such as the LCR and the Federal Reserve's liquidity stress-testing requirements, which are designed to address many of the same liquidity needs under stressed conditions.

- Excessive conservatism in assumptions, e.g., no access to the Federal Reserve's discount window, even for bank subsidiaries that have been fully recapitalized and otherwise qualify for access; full ring-fencing by foreign regulators.

- There is the risk that RLAP may, over time, become skewed in favor of pre-positioning of assets, with reduced flexibility for affected banking organizations in deploying liquidity where needed and an increased risk of trapped liquidity.

Recommendations

- **Modification of agencies' resolution planning guidance on RLAP and RLEN**
  - Defer to firms' own analysis and experience of inter-affiliate frictions in stressed conditions, subject to appropriate supervisory review.
  - Reassess the need for the RLAP standard, which is largely duplicative of the LCR rule and the Federal Reserve's liquidity stress-testing requirements and does not contribute meaningfully to firms' liquidity management tools.
  - In the alternative, to the extent that RLAP is retained as a standard, continue to recognize flexibility with respect to the balance between maintaining liquidity at a parent or funding entity and pre-positioning liquidity, so that RLAP is not used to prescribe particular pre-positioning arrangements.
  - Clarify that each affected banking organization, in calculating RLEN, may assume normal course, non-extraordinary access to Federal Reserve or Federal Home Loan Bank borrowing facilities to the extent the banking organization meets applicable collateral, capital and other requirements for such borrowings.
  - Harmonize the role of RLAP and RLEN in the resolution planning context with other liquidity requirements, such as the Federal Reserve's liquidity stress testing requirements in Regulation YY, to ensure that RLAP and RLEN do not become *de facto* liquidity requirements under normal economic conditions.

Means of Implementation

- These changes would not require legislative amendments. They could be accomplished by the agencies modifying their resolution planning guidance in certain respects and leaving it unchanged in others, as discussed in Chapter 5.

Chapter 4

THE VOLCKER RULE

Relevant Agencies

- CFTC
- FDIC
- FRB
- OCC
- SEC

Chapter 4 – The Volcker Rule

A. Original Problem to be Remedied

The Volcker Rule was a late addition to the Dodd-Frank Act. Neither the statutory text nor the legislative history includes a stated purpose for the Volcker Rule.[1] Only one hearing was held on the provision, and testimony was limited. As a result, the policy basis, including any empirical support for it, has been the subject of an unresolved debate. Congress clearly intended for the Volcker Rule to prohibit banking entities from engaging in proprietary trading, an activity that Former Chair Volcker stated should be outside the scope of permissible banking activities. The purpose behind the funds portion of the Volcker Rule is even harder to pin down. Congress intended to prevent banking entities from evading the direct ban on proprietary trading by conducting proprietary trading indirectly through a hedge fund or private equity fund. The funds portion also reflects a concern about the bailout of affiliated funds.

"[The Volcker Rule] certainly would not have solved the problem at AIG or solved the problem with Lehman Brothers, alone."[2]

– Paul Volcker, Former Chair, Federal Reserve

Proprietary trading did not cause the financial crisis and did not contribute to the failure of any banking organization. Paul Volcker himself conceded that proprietary trading was "not central" to the financial crisis and acknowledged in a congressional hearing that the restrictions in the Volcker Rule would not have prevented the financial crisis.

B. Need for Rebalancing

"[T]here are areas [of the Dodd-Frank Act] where I think the case for change has become fairly strong. The Volcker rule is one."[3]

– Daniel K. Tarullo, Governor, Federal Reserve

The Volcker Rule is vague, overbroad and unnecessarily complex, and has produced unintended adverse consequences on the markets. The line between proprietary trading and permissible market making has been exceedingly difficult to draw. As a result, the Volcker Rule has chilled a

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[1] The term Volcker Rule is widely, and somewhat confusingly, used to describe both the statutory text, Section 13 of the BHC Act, and the regulations which have implemented it.

[2] *Examining Recent Restrictions Placed on Commercial Banks and Bank Holding Companies' High-Risk Investment Activities: Hearing Before the S. Comm. On Banking, Hous. & Urban Affairs*, 111th Cong. (Feb. 2, 2010) (statement of Paul Volcker, Former Chairman, Fed. Reserve) (link).

[3] Daniel K. Tarullo, Governor, Fed. Reserve, Departing Thoughts (Apr. 4, 2017) (link).

> "[The Volcker Rule] is a rule that's very difficult to enforce, because it's very difficult to distinguish between what are proprietary trades and what are client trades."[4]
>
> *– Tobias Adrian, director of monetary and capital markets department, IMF, and former senior research official, Federal Reserve*

vast amount of desirable market making, reducing the liquidity of the markets, especially the market for corporate debt instruments, and inhibiting capital formation. The overbroad definition of covered funds has interfered with traditional lending and asset management, and has had an adverse impact on securitization markets, as described in Chapter 9. The requirements to show and document that a particular activity is not proprietary trading and that a particular affiliate or unaffiliated vehicle is not a covered fund has imposed an extremely heavy compliance burden on the industry, without any benefit to safety and soundness.

There has been a growing number of prominent policymakers who recognize that the Volcker Rule is overly complex and needs to be narrowed. As Federal Reserve Governor Daniel K. Tarullo recently stated, the Volcker Rule, as implemented, is "too complicated," "may be having a deleterious effect on market making," relies on a difficult and costly "inquiry into the intent of the bankers making the trades" and "applies to a much broader group of banks than is necessary is to achieve its purpose." Moreover, "[a]chieving compliance under the current approach would consume too many supervisory, as well as bank, resources relative to the implementation and oversight of other prudential measures."[5]

1. The Volcker Rule is Too Complex (Core Principles (f) and (g))

> "The number one problem with the Volcker Rule is it's too complicated."[6]
>
> *– Steven T. Mnuchin, Secretary of the Treasury*

The Volcker Rule, as implemented, is too complicated. Its complexity is a problem for both the regulators responsible for implementing the statute and for the banking entities required to comply with it. This characteristic of the Volcker Rule is inconsistent with Core Principles (f) and (g)—making regulation efficient, effective and appropriately tailored, and restoring public accountability within the Federal financial regulatory agencies.[7]

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[4] Andrew Mayeda, *IMF Calls Volcker Rule Hard to Enforce and Threat to Liquidity*, BLOOMBERG (Apr. 20, 2017) (link).

[5] Daniel K. Tarullo, Governor, Fed. Reserve, Departing Thoughts (Apr. 4, 2017) (link).

[6] Steven Mnuchin, *Trump Cabinet picks: Ross and Mnunchin's exclusive interview with CNBC's 'Squawk Box'*, Interview on CNBC (Nov. 30, 2016) (link).

[7] Ron Kruszewski, *Volcker Rule Testimony of SIFMA Witness Ron Kruszewski at HFSC Hearing* (Mar. 29, 2017) (link).

The Volcker Rule regulations run over 950 pages and have more than 2,800 footnotes, reflecting the three and a half year struggle by five regulators to rationalize the vague, overbroad and somewhat contradictory statutory text. The rule relies upon a vague intent-based standard to define proprietary trading which has resulted in an overly burdensome compliance and metrics reporting regime with which firms are required to comply in order to prove that they have not engaged in impermissible proprietary trading.

Member firms each month report millions of metrics data points to the regulators and have implemented thousands of pages of policies and procedures and extensive internal controls.

"[The Volcker Rule is] just too complicated, it's too burdensome, and we need to take another look. Congress should take another look at the scope of the rule. I think we the regulators need to take a look at the way the rule has been written and try to do it in a simpler, more effective way."[8]

– Jerome H. Powell, Governor, Federal Reserve

Banking entities must analyze and monitor thousands of legal entities, including all internal entities and even those with which they often have only the slightest relationship, in order to determine whether or not they are covered funds. In addition, foreign banking organizations are required to analyze and monitor thousands of foreign funds and entities to determine whether they would be deemed to be affiliates and therefore banking entities, subject to trading and fund restrictions not suited to them. All banking entities must maintain extensive documentation of these determinations, without any benefit to safety and soundness. Firms must also determine whether the interests they hold in potential covered funds are ownership interests under a complicated, multi-factor test that does not fit well with typical fund structures. The complexity of the rule results in firms needing to conduct these analyses, often with multiple outside counsel, on entities that bear little resemblance to what have ordinarily been considered hedge funds or private equity funds. The legal entities that must be analyzed include not only traditional funds, but also subsidiaries, acquisition vehicles, joint ventures and even publicly traded companies listed on non-U.S. exchanges, securitization vehicles, and internal structuring entities.

This approach has resulted in otherwise beneficial market intermediation, capital formation, risk mitigation and other safety-and-soundness-enhancing activities, such as hedging, being restricted in a manner not justified by whatever benefits are achieved by prohibiting banking entities from

[8] Jerome H. Powell, Governor, Fed. Reserve, Q&A Session at the Global Finance Forum (Apr. 20, 2017).

engaging in proprietary trading. As recognized by Tarullo, the approach has not worked and the approach must be reevaluated.[9]

The Volcker Rule's complexity is exacerbated by the fact that it is administered by five co-equal regulatory agencies. Each of these agencies has its own congressional mandate, history and interpretative approach and an effective veto over any interpretation or simplification of the Volcker Rule that the others might agree on. In the almost two years since the implementing regulations became effective, the five regulators have only been able to agree on 21 FAQs, most of which have been focused on administrative matters such as metrics reporting dates and funds seeding period treatment. This inefficient administrative process means that the rule's excessive complexity may never be simplified without legislative action. Indeed, it may be easier to bring about legislative change than for all five agencies to agree on meaningful simplification.

2. The Volcker Rule Has a Negative Impact on Market Liquidity and Capital Formation (Core Principle (c))

The narrow set of permissible market-making related activities under the Volcker Rule and the prescriptive conditions for engaging in those activities have led many financial institutions to scale back their trading operations as well as their inventories of financial assets. These financial institutions may take a conservative approach, even for types of trading activities permitted under the Volcker Rule, in order to avoid uncertainty about whether the activities are within the bounds of the complex parameters of the Volcker Rule. The Volcker Rule's proprietary trading restrictions have reduced liquidity in financial markets and have resulted in higher market execution costs and delays for would-be issuers and investors.

> The Volcker Rule may have "serious consequences for corporate bond market functioning in stress times."[10]
>
> *– Federal Reserve Finance and Economics Discussion Series Working Paper (Sept. 2016)*

That the Volcker Rule has impacted firms' ability to make markets and provide market liquidity, particularly in times of stress, is supported by data in a recent Federal Reserve staff paper, which concluded that "the Volcker

[9] Daniel K. Tarullo, Governor, Fed. Reserve, Departing Thoughts (Apr. 4, 2017) (link).

[10] Jack Bao, Maureen O'Hara & Alex Zhou, *The Volcker Rule and Market-Making in Times of Stress* (Federal Reserve, Finance and Economics Discussion Series Working Paper 2016-102).

Rule has a deleterious effect on corporate bond liquidity and dealers subject to the Rule become less willing to provide liquidity during stress times."[11]

> "[I]t may be worth considering giving greater discretion to trading desks that facilitate client business to intervene when markets are illiquid and volatile."[12]
>
> *– William C. Dudley, President and CEO, Federal Reserve Bank of New York*

This adverse impact on market liquidity will cause the greatest problems in times of stress. During times of stress, financial institutions will be disincentivized from providing liquidity, precisely when doing so could stem a nascent crisis, if trading in a stressed environment subjects them to regulatory risk and potential second-guessing resulting from unclear and complex standards. The chilling effect introduced by the Volcker Rule could cause problems in one part of the financial sector to spread quickly to the broader economy when it otherwise could have been absorbed by market liquidity—a pro-cyclical effect that could exacerbate any crisis.

It is also inconsistent with Core Principle (c)—fostering economic growth and vibrant financial markets.

3. The Covered Funds Provisions Are Overbroad, Burdensome and Impinge on Traditional Banking and Asset Management Activities (Core Principles (c) and (f))

The covered funds provisions of the Volcker Rule are broader than necessary to prevent banking organizations from engaging in proprietary trading indirectly through covered funds or from bailing out affiliated funds. The implementing regulations have also imposed burdensome compliance requirements, including a requirement that banking entities prove and document that any legal entity with which a banking entity has only the slightest relationship is not a covered fund.

The statute and implementing regulations both rely on an overbroad definition of hedge funds and private equity funds that was developed under a different body of law for unrelated purposes. Vehicles that had never before been considered to be hedge funds or private equity funds, and that do not engage in proprietary trading, were swept into the covered fund restrictions by that overbroad definition of covered fund. Such vehicles may include securitizations, certain trusts established for client family wealth management, vehicles that facilitate traditional lending and

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[11] Id.

[12] William C. Dudley, President and CEO, Fed. Reserve Bank of N.Y., Principles for Financial Regulatory Reform (Apr. 7, 2017) (link).

financing activities, and entities used for internal corporate structuring, among others.

These features of the covered funds provisions are inconsistent with Core Principles (c) and (f)—fostering economic growth and vibrant financial markets, and making regulations efficient, effective and appropriately tailored.

Many of these adverse features arise from the implementing regulations and are not compelled by the statute. The statute authorizes the five regulatory agencies to exclude by regulation any entity from the scope of the term covered fund. The agencies have exercised that authority in the implementing regulations by excluding twelve categories of vehicles from the definition of covered fund. They could use the same authority to exclude all private funds that are not principally engaged in proprietary trading. If they did so, the Volcker Rule would be more consistent with Core Principles (c) and (f).

4. The Volcker Rule Is Duplicative (Core Principle (f))

Structural limits like the Volcker Rule are unnecessary and inconsistent with Core Principle (f) because a banking entity's trading and covered fund activities are already subject to strong prudential standards, including stringent capital and liquidity requirements. In fact, since the financial crisis, several rules have been implemented that have significantly increased the quantity and quality of the capital and liquidity of the firms that are subject to the Volcker Rule, as discussed in Chapters 2 and 3.[13] These other measures provide more flexible and targeted methods to regulate proprietary trading and covered fund activities and therefore constitute more efficient, equally effective and more appropriately tailored regulations.

[13] For example, banking organizations are subject to the U.S. Basel III capital requirements (risk-based capital standards), SLR (leverage ratios), G-SIB surcharge (enhanced risk-based capital surcharge for the most systemically important banking organizations), CCAR (stress testing that sets de facto capital requirements even higher than what is prescribed by the risk- and leverage-based standards) and the LCR (liquidity requirements to help banking organizations survive short-term stress conditions).

"[O]n balance, we believe that the Volcker Rule should be repealed."[14]

– Jeremy Stein, Former Governor, Federal Reserve, et al.

C. Proposed Recommendations

1. Repeal the Statute

- SIFMA believes that the best response to the Volcker Rule's many problems would be to repeal the statute in favor of the traditional prudential regulatory framework applicable to banking organizations. This framework includes stringent capital and liquidity requirements and general safety and soundness standards. This option would be the most efficient path to reversing the negative impact of the Volcker Rule on market liquidity, capital formation, lending, asset management and securitization. It is also consistent with the proposed Financial CHOICE Act, which contains an outright repeal of the Volcker Rule.

2. To the Extent Not Repealed, the Volcker Rule, at Both a Statutory and Regulatory Level, Should Be Reevaluated under the Following Guideposts

- To the extent the Volcker Rule is not repealed, Congress and the regulators should reevaluate the Volcker Rule under the following guideposts:
  - Recalibrate the Volcker Rule to prohibit stand-alone proprietary trading, and proprietary trading through covered funds, without chilling legitimate market-liquidity-providing activities, such as market making, consistent with traditional safety and soundness standards.
    - Such recalibration is necessary since the Volcker Rule has negatively affected market liquidity and capital formation.
  - Redefine proprietary trading as short-term trading operated by a business unit that is wholly unrelated to financial intermediation, risk management or asset-liability management.
    - The definition of proprietary trading and the prescriptive, conditional exemptions chill beneficial market making, hedging and asset-liability management activities.

[14] Jeremy C. Stein, Former Governor, Fed. Reserve, et. al. *The Financial Regulatory Reform Agenda in 2017* (Feb. 9, 2017) (link).

    - This solution would be in line with the original goals of prohibiting banking entities from engaging in stand-alone proprietary trading and preserving safety and soundness.

- Simplify the statute to prohibit only the types of short-term trading that the Volcker Rule was intended to prevent, without an intent-based standard, by establishing a framework that allows for safe harbors and provides banking organizations the flexibility to tailor their risk management and compliance programs to their structure and activities.

    - This solution would resolve the inherent difficulty in implementing the existing intent-based statutory proprietary trading prohibition, which has resulted in regulations that are overly complex, require an outsized compliance infrastructure and metrics and often capture beneficial activities beyond the policy of the Volcker Rule.

- Limit the definition of covered funds to Section 3(c)(1) or 3(c)(7) funds that are principally engaged in proprietary trading, as redefined above, while limiting bail-outs of sponsored covered funds.

    - The covered funds provision uses existing legal concepts developed for unrelated purposes, resulting in a scope far beyond the intended focus on the use of hedge funds and private equity funds to engage in indirect, impermissible proprietary trading.

    - It would also preserve safety and soundness, the ability of banking entities to engage in beneficial and legitimate liquidity providing activities, regardless of the choice of structure, including investing alongside clients in capital formation transactions, and risk management activities and would avoid sweeping in core asset management, ordinary corporate structures, securitization structures and related activities that are far removed from the policy goals.

- Exempt community banks and other small banking entities from the Volcker Rule, which otherwise applies to banking entities regardless of size.

- This exemption would alleviate the undue compliance burden on small banking entities.

- Designate a single regulator to be responsible for implementing, interpreting and examining compliance with the Volcker Rule.
  - The Volcker Rule requires the involvement of five regulators, leading to interpretive and implementation uncertainties and coordination difficulties.
  - This harmonization would make regulation more efficient and effective and be a step towards rationalizing the regulatory framework.
- Ensure that any reforms to the Volcker Rule do not impose restrictions on an IDI that would not apply to other affiliates of the bank holding company or operate to have a disparate impact on a banking group that utilizes a subsidiary structure instead of a branch structure, given that the Volcker Rule is a prudential regulation that applies to large bank holding companies and all their affiliates, whether a bank or broker-dealer.

3. Statutory Changes to Align with the Guideposts

- To align the Volcker Rule statute to these guideposts, Congress should amend the statute, including in the following ways:
  - ***Proprietary Trading***
    - Limit the definition of proprietary trading to focus on short-term trading, reducing its complexity and alleviating the negative impact of the intent-based language on market liquidity and capital formation.
      - Amend the definition of proprietary trading to include only the purchase or sale as principal of a financial instrument by a business unit operated for the purpose of generating profits from short-term price movements or short-term trading strategies.
      - Provide a safe harbor from the definition of proprietary trading for any purchase or sale as principal for the purpose of, or in connection with, engagement in financial intermediation activities or asset-liability management.

> "We want to work on the definition [of proprietary trading]… This should be relatively simple. If you are sitting in a customer business and doing customer trades, facilitating the business. . . . I think the right thing to conclude is that if you are acting within the context of a customer business, there is clarity that banks can commit capital and we will work with regulators to make sure there is proper liquidity in the system."
>
> *– Steven T. Mnuchin, Secretary of the Treasury*

  - — Provide an exclusion from the definition of proprietary trading for any activity resulting in, or resulting in the disposal of, a position that is held for more than 60 days, or held to maturity and has an original maturity of greater than 60 days.

- □ Promote and encourage lending, capital formation and capital markets liquidity through amendments to existing, or the creation of new, exemptions to the proprietary trading restriction.

  - — Amend the underwriting and market making exemptions to replace the RENTD requirement with a clearer exemption for the purchase, sale, acquisition or disposition of activities in connection with financial intermediation.

  - — Simplify the risk mitigating hedging exemption to allow for prudent risk management by creating an exemption for hedging activities designed to mitigate existing or anticipated risks to a banking entity.

  - — Allow for the trading of all government obligations and related derivatives.

  - — Create an exemption for the purpose of managing the balance sheet exposures and liquidity risks of a banking entity that are undertaken in connection with liquidity management or asset-liability management.

o ***Covered Funds***

- □ Limit the scope of the covered funds provisions to Section 3(c)(1) or 3(c)(7) funds that are principally engaged in impermissible proprietary trading.

- □ Provide that the prohibition on acquiring or retaining ownership interests in covered funds applies only to equity voting interests.

- □ Ensure that the covered funds provisions do not interfere with traditional banking activities and asset management, including investing alongside clients.

- Remove unnecessary restrictions on asset management activities, including the name-sharing restriction and limitations on investments by employees, directors, or officers who directly or indirectly provide services to a sponsored covered fund.

- Incorporate into the Super 23A provisions the exemptions contained in regular Section 23A of the Federal Reserve Act and Regulation W and apply only to sponsored covered funds.

- Permit banking entities to buy and sell ownership interests in covered funds for financial intermediation, risk management, or asset-liability management purposes, without being subject to additive capital limits or requirements.[15]

- Provide seeding authority for funds and extend the initial seeding period to three years to provide the important ability to establish track records for covered funds in order to attract third party investors as expected by the market.

- Exclude foreign public and foreign private funds from the definition of banking entity.

- ***Compliance***

  - Permit banking entities to develop a compliance program tailored to their activities, including safe harbors to promote beneficial activities.

- ***Single Regulatory Agency***

  - Provide sole authority to the Federal Reserve to implement, interpret and examine compliance with the Volcker Rule.

4. Regulatory Changes to Align with the Guideposts

- Even in the absence of legislation, the five regulators have broad discretion to simplify the implementing regulations and bring them into line with the guideposts, including by making the following changes:

[15] This change would alleviate unnecessary and burdensome competitive disadvantages for U.S. banking organizations. Retaining the prohibition on bailouts of sponsored funds would address a likely core policy concern of the covered fund provisions.

- ***Proprietary Trading***

  - Amend the regulations to recognize and place more reliance on existing safety and soundness controls, such as prudential risk limits and risk management, as the primary control for market making and underwriting.

  - Simplify the RENTD requirement in order to rebalance the regulations that apply to market making and underwriting so as to preserve market liquidity and the vibrancy of capital markets, so that RENTD is presumed to be met when financial intermediation or related hedging are involved.

  - Simplify the risk mitigating hedging requirements to allow for prudent risk management by clarifying that the risk-mitigating hedging exemption is designed to mitigate existing or anticipated specific risks to a banking entity.

  - Recalibrate the definition of trading account to avoid sweeping in activity that was never intended by Congress to be captured under the statutory text, such as asset-liability management, liquidity management and investment activity.

    - This recalibration can be achieved by removing the market risk capital rule test and status test prongs, and replacing the rebuttable presumption in the purpose test with a safe harbor from trading account treatment for any position that is held for more than 60 days or held to maturity and has an original maturity of greater than 60 days.

    - Amend the liquidity management exclusion to cover instruments other than securities and to cover all activities for the purpose of managing balance sheet exposures and liquidity risks that are undertaken in connection with the liquidity management or asset-liability management plan.

  - Permit trading in all government obligations and related derivatives for purposes of the government obligations exemptions.

  - Create clear exclusions from the definition of proprietary trading for error accounts, collateral transformation and optimization, transactions entered into for purposes of meeting regulatory, self-regulatory and exchange requirements, short-term foreign exchange funding transactions and interaffiliate and intraaffiliate transactions.

- Explicitly permit back-to-back derivatives activity to qualify as riskless principal and remove references to Regulation Y in the riskless principal exemption.

- ***Covered Funds***
  - Limit the scope of the covered funds provisions to Section 3(c)(1) or 3(c)(7) funds that engage in impermissible proprietary trading.
    - Exclude from the definition of covered funds vehicles that are not principally engaged in impermissible proprietary trading.
    - Consistent with this general exclusion, create separate exclusions from the definition of covered funds for:
      - Family wealth trusts/vehicles.
      - U.S. or non-U.S. public funds that are qualified to be offered to retail investors, or have their shares listed on a securities exchange.
      - Securitizations, internal structuring vehicles, and venture capital, infrastructure and credit funds, which do not engage in impermissible proprietary trading and invest only in instruments in which a banking entity is permitted to invest.
      - Vehicles that are created on the order of a client, such as customized client-intermediation vehicles, that have only one investor, including affiliates, and such investor is unaffiliated with the sponsor, manager, arranger, advisor, trustee or its equivalent of the vehicle.
  - Remove the “other similar interest” prong of the ownership interest definition.

- Ensure that the covered funds provisions do not interfere with traditional banking activities and asset management, including investing alongside clients.
- Permit banking entities to buy and sell ownership interests in a covered fund for financial intermediation, risk-management or asset-liability management purposes, without being subject to additive capital limits or requirements.
- Provide for automatic extensions of the initial seed period, absent Federal Reserve action.
- Incorporate into the Super 23A provisions the exemptions contained in regular Section 23A of the Federal Reserve Act and Regulation W.
- Exclude foreign public and foreign private funds from the definition of banking entity.

o ***Compliance***

- Permit banking entities to develop a compliance program tailored to their activities, including safe harbors to promote beneficial activities.
- Significantly simplify and reduce the administrative burden of Appendix B and permit banking entities to develop a compliance program tailored to their activities.
- Simplify the number of metrics and the frequency with which they have to be reported.
- Expand the banking entities that qualify for simplified compliance program requirements to community banks and other small banking entities.
- Eliminate documentation and recordkeeping requirements for entities that are not covered funds, with a safe harbor for entities determined in good faith by the banking entity to be outside or excluded from the covered fund definition.
- Permit a knowledge qualifier in the annual CEO attestation.

- ***Regulatory Coordination***
  - Require increased regulatory coordination, including a requirement for all five regulators to enter into interagency information sharing and coordination agreements.

Chapter 5

LIVING WILLS

Relevant Agencies

- FDIC
- FRB

Chapter 5 – Living Wills

A. Original Problem to be Remedied

The purpose of the resolution plan, or living will, requirement under Title I of the Dodd-Frank Act is to prevent the failure of a banking organization from destabilizing the U.S. financial system, and to ensure all losses are imposed on private sector investors. The requirements of advance planning are therefore tightly aligned with Core Principle (b) which reiterates the importance of preventing future taxpayer funded bailouts.

Section 165(d) of the Dodd-Frank Act requires banking organizations with $50 billion or more in consolidated assets and nonbank financial companies designated by FSOC to submit periodic living wills to the Federal Reserve and FDIC showing how they can be resolved in a rapid and orderly manner under the Bankruptcy Code should they encounter material financial distress.

"[W]e've had a lot of years of working, many cycles of these plans now, we've made a great deal of progress. We really have. These firms are much more resolvable, they've got a better sense, their legal entities are more rationalized. . . . They've really thought about it and incorporated the whole thought of resolution into the planning of their businesses in a way that is really remarkable. . . . So I actually think it's one of the unsung successes of the post-crisis era. . . . I do think we should acknowledge the gains and we've gotten to a point where we can give much more explicit guidance."[1]

– Jerome H. Powell, Governor, Federal Reserve

The Federal Reserve and FDIC issued a joint final rule in 2011 implementing Section 165(d) of the Dodd-Frank Act, and since then have issued multiple rounds of guidance and feedback. The Federal Reserve and FDIC may jointly determine that a living will is not credible and, if the living will's deficiencies are not remediated, impose more stringent capital or liquidity requirements or restrictions on growth, activities or operations or even require divestitures. In response, banking organizations have made significant business-as-usual changes, including simplifying their structures and rationalizing their operations, to facilitate their rapid and orderly resolution and imposition of all losses on private sector investors without relying on taxpayer funds or destabilizing the U.S. financial system, should they ever need to be resolved.[2] Moreover, as discussed in the Executive

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[1] Jerome H. Powell, Governor, Fed. Reserve, Q&A Session at the Global Finance Forum (Apr. 20, 2017).

[2] Most U.S. G-SIBs have proposed an SPOE strategy for resolution under the Bankruptcy Code in their living wills. Under the SPOE strategy, the banking organization's top level public company, a BHC, would enter bankruptcy proceedings under Chapter 11 of the Bankruptcy Code, but its subsidiaries would be recapitalized and would continue operating or be wound down outside of resolution proceedings. In some cases, the SPOE strategy would be accomplished through the transfer of the BHC's subsidiaries to a new holding (….continued)

Summary, the U.S. banking sector is more resilient with higher capital and loss absorbing capacity in the form of TLAC.

B. Need for Rebalancing

A properly designed living will requirement would be good policy, but to make the requirement most effective, its implementation should be more measured, transparent and appropriately tailored to the size of banking organizations.

Resolution planning was a novel concept when the Federal Reserve and FDIC issued the final rule in 2011, and implementing any new supervisory regime—particularly one that results in the production of the volume of information that this one does—poses challenges. The Federal Reserve and FDIC responded sensibly by refraining from making major judgments on the first living wills filed and making the living wills process iterative.

The implementation of the living will requirement over the last five years, however, has led to inefficiencies that have resulted in unnecessary and significant costs not only for the banking organizations that produce them but also for the Federal Reserve and FDIC. Having learned immensely from the work done over the last five years, the Federal Reserve and FDIC views on the objectives, requirements and assessment criteria of living wills should be largely settled, and the time has come to recraft the living will process.

The sheer volume of filings has impeded the ability of the agencies to streamline the requirements. The first living wills were filed in July 2012 by the largest and most systemically important U.S. banking organizations. The Federal Reserve and FDIC have since received over 500 living wills from 145 living will filers. The living wills requirement was drawn more broadly than necessary for U.S. financial stability. The agencies have received so many living wills because the requirement applies not only to the largest, most systemically important banking organizations but to any

(continued….)

company operated for the benefit of the BHC's bankruptcy estate. The BHC's TLAC would be left behind to absorb losses in the BHC's bankruptcy.

banking organization with $50 billion or more in total consolidated assets.[3] The statutory threshold of $50 billion in total consolidated assets reached more deeply into U.S. regional banks than, in hindsight, was needed and, as a result of interpretations by the Federal Reserve and FDIC legal staff who viewed the $50 billion as a global assets threshold, captured many foreign banks with limited operations in the United States. Banking organizations with an insured bank in their structure that is over $50 billion are also required to submit annual IDI resolution plans to the FDIC under a separate, duplicative IDI rule. 36 banking organizations filed IDI plans in 2015, nearly all of which filed living wills under the Section 165(d) rule as well. The FDIC has received over 100 separate IDI plans since the rule was issued.

Agency guidance, both confidential and public, has accrued each year. Rather than hone in on an appropriate and limited set of requirements for an effective resolution plan, agency guidance has imposed accretive informational and other requirements. The agencies have not yet looked back to refine, consolidate and rationalize past guidance, and banking organizations have had no choice but to meet all of the guidance that has been issued in each living will regardless of whether past guidance is redundant or creates unnecessary work that is no longer seriously reviewed by the regulators.

Agency guidance has, in some instances, had a significant impact on banking organizations' business-as-usual operations. For example, 2016 guidance requires the largest banking organizations to develop new and burdensome modeling for resolution capital and liquidity execution needs for each material entity and to hold sufficient resources to meet these needs.[4] As discussed in Chapters 2 and 3, and because of the significant

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[3] U.S. banking organizations may file a tailored living will if they have less than $100 billion in nonbank assets and their total IDI assets comprise 85% or more their total consolidated assets Similarly, foreign banking organizations may file a tailored living will if they have less than $100 billion in U.S. nonbank assets and their total U.S. IDI, branch and agency assets comprise 85% or more of their U.S. total consolidated assets. The Federal Reserve and FDIC have also permitted foreign banking organizations with limited U.S. operations to file highly abbreviated plans that focus on material changes. Despite these efforts, many banking organizations that are not systemically important are still required to file full living wills annually, and the FDIC and Federal Reserve could devise further tailoring to make the living wills process more efficient. 12 C.F.R. § 243.4(a)(3).

[4] FED. RESERVE & FDIC, GUIDANCE FOR 2017 §165(D) ANNUAL RESOLUTION PLAN SUBMISSIONS BY DOMESTIC COVERED COMPANIES THAT SUBMITTED RESOLUTION PLANS IN JULY 2015 4–8 (Apr. 13, 2016); Fed. Reserve, SR Letter 14-1, *Heightened Supervisory*

(….continued)

consequences of a living will being jointly deemed non-credible, resolution liquidity execution needs, rather than LCR, may serve as the binding constraint for liquidity for some banking organizations. None of the guidance has been subject to public and notice comment periods consistent with the Administrative Procedure Act, and the lack of public notice and comment in formulating what are effectively binding rules circumvents the spirit and letter of the Administrative Procedure Act. It also eliminates banking organizations' and other parties' opportunities to suggest improvements to or otherwise weigh in on guidance before it becomes effective, meaning that much of the guidance has not benefitted from insight from those outside of the agencies themselves.

> "FDIC and Federal Reserve officials told us that they recognize the constraints the companies have experienced because of the timing of the regulators' feedback. . . . [T]he resolution plan rule's annual filing cycle may not be feasible. . . . With regard to resolution plans, the agencies must be able to provide not only quality information—such as guidance or feedback—to companies but also sufficient time for the companies to incorporate the information in their plans. Absent a longer filing cycle, the rule may not effectively allow for the achievement of its intent."[6]
>
> *– GAO Report on Living Wills*

The agencies' accretive and sometimes contradictory requirements and the very high stakes associated with a non-credibility determination have led banking organizations to submit living wills that attempt to address every possible contingency, in the hope of anticipating the next element the agencies will find necessary for effective planning. These requirements have led to lengthy living wills, especially for the largest banking organizations. Federal Reserve Chair Janet L. Yellen testified, "these are extremely complex documents for these firms to produce . . . We're looking at plans that run into tens of thousands of pages."[5]

The requirement that living wills be submitted annually—as well as the length and complexity of living wills—has meant that Federal Reserve and FDIC staff has not been able to provide effective guidance and feedback in a timely manner. Long delays in receiving guidance as the agencies' staff engaged in their own internal debate and discussion has imposed higher costs than needed on banking organizations. In many cases, the agencies have not been able to digest living wills and issue guidance and feedback until close to a year after the living wills were submitted, causing significant

(continued….)

Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies – Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions 2 (Jan. 24, 2014).

[5] *Federal Reserve's Second Monetary Policy Report for 2014: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 113th Cong. (July 15, 2014) (statement of Janet L. Yellen, Chair, Fed. Reserve).

[6] GOV'T ACCOUNTABILITY OFFICE, RESOLUTION PLANS: REGULATORS HAVE REFINED THEIR REVIEW PROCESSES BUT COULD IMPROVE TRANSPARENCY AND TIMELINESS 33–34 (Apr. 12, 2016).

inefficiencies. For example, the agencies provided guidance in April 15, 2013 to banking organizations that submitted living wills on July 1, 2012, only weeks before the July 1, 2013 deadline for these banking organizations to submit their 2013 living wills. These banking organizations had to overhaul their living wills and scrap thousands of hours of work to meet the new guidance, despite the agencies extending the deadline to October 1, 2013. In 2014, the Federal Reserve and FDIC provided feedback to banking organizations on living wills they had filed in 2013 on August 5, *after* these banking organizations had already submitted new living wills to the agencies on July 1, 2014. When the Federal Reserve and FDIC jointly determined five banking organizations to have non-credible 2015 resolution plans, guidance was not issued until April 2016, after the banking organizations had made significant progress towards what they expected to be their July 2017 living wills, which then needed to be discarded.

Due to the combination of the technical nature of the plans, accretive regulatory requirements and delays in receiving feedback, among other reasons, the costs of producing and reviewing living wills annually has been enormous. The FDIC spends approximately $4 million per year on living wills, and one banking organization spent $105 million to produce a living will.[7] Nearly all large banking organizations subject to the requirement have teams of dedicated professional and outside consultants and lawyers working all year round to produce annual living wills.

> "Companies and the public have a limited basis for understanding how the regulators are fulfilling their responsibility under the resolution plan rule, which could undermine the public's confidence in the resolution planning process."[8]
>
> – *GAO Report on Living Wills*

Adding to the expense and inefficiency of the living will process, the Federal Reserve and FDIC's assessment criteria has not been publicly disclosed. Public disclosure of the agencies' assessment criteria would give banking organizations greater opportunity to take proactive steps to enhance their living wills, but without it, banking organizations do not know how the agencies will assess their living wills before submitting them. For example, although guidance issued by the agencies is instructive, the agencies could ultimately deem a living will to not be credible for reasons never before mentioned.

[7] Id. at 50, 53.

[8] Id. at 29.

In addition, although the FDIC issued a request for public comment on using the SPOE strategy to implement OLA[9]—which provides the FDIC with the ability to resolve systemically important financial institutions when using the Bankruptcy Code is expected to have a serious adverse effect on U.S. financial stability—the FDIC has not disclosed its general preferred strategy or presumptive path for resolving these institutions under OLA to the public or disclosed institution-specific preferred strategies or presumptive paths to the institutions themselves. Given the overlap between the FDIC's efforts under OLA and living wills, improved transparency and collaboration would only improve resolvability and reduce inefficiencies. SIFMA supports the President's request that the Treasury Secretary issue a report that provides a thorough review of OLA and providing recommendations for improvement.

Despite the challenges and inefficiencies of the living wills process, the Federal Reserve and FDIC's efforts, combined with substantial investments by banking organizations to meet resolution planning requirements has resulted in safer and more resolvable banking organizations. As discussed in the Executive Summary, banking organizations have twice as much capital, three times as much liquidity and over five times as much usable total loss absorbing capacity as in 2008. The adoption of the ISDA 2015 Universal Resolution Stay Protocol will mean that parties to over 90% of bilateral OTC derivatives will be stayed from terminating derivatives immediately upon the entry of a banking organization into insolvency proceedings, substantially diminishing the risk of disorderly resolution and market contagion.[10] Given the substantial progress made over the last five years, it is time to rationalize and streamline the living will process.

[9] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (Dec. 18, 2013) (describing and asking questions about the SPOE resolution strategy without saying whether it is the FDIC's preferred strategy or presumptive path under Title II of the Dodd-Frank Act).

[10] Mark Carney, Governor, Bank of England, The Future of Financial Reform (Nov. 17, 2014) (link).

> "There has been a transformational change in the United States and internationally since the financial crisis in regard to the resolution of systemically important financial institutions that perhaps has been underappreciated."[11]
>
> *– Martin Gruenberg, Chair, FDIC*

C. Proposed Recommendations

The key strategic principles for effective living wills should now be largely settled, and the following proposals would help reduce inefficiencies in the living wills process without sacrificing the stability of the U.S. financial system:

- All requirements and guidance governing living wills, including related supervisory guidance such as SR Letter 14-1, should be streamlined and rationalized into a single consolidated rule that is subject to a public notice and comment period before becoming final, consistent with the requirements of the Administrative Procedure Act.
- Section 165(d) of the Dodd-Frank Act requires periodic, not annual, living wills. A banking organization with no un-remediated deficiencies jointly identified by the agencies should only be required to file:
  - A refresh of its living will every two years to update information that if not updated would meaningfully impair the living will's usefulness[12]; or
  - A revised living will if either there has been a change in the banking organization's business or operations that would have a material detrimental impact on its resolution strategy, or the Federal Reserve and FDIC have adopted new resolution planning rules or guidance.
- Such a revised living will should be required no sooner than one year after the changed circumstance occurs or new guidance is effective and should only cover the changed circumstance or new guidance.
- A company with an un-remediated joint deficiency should only be required to make an additional filing to cure that deficiency, rather than being required to refile the other parts of its plan.[13]

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[11] Martin J. Gruenberg, Chair, FDIC, Remarks to the FDIC Banking Research Conference (Sept. 17, 2015) (link).

[12] The final rule allows living wills to include previously submitted information by reference but substantial new information requests each year have prevented banking organizations from utilizing references to past submissions. 12 C.F.R. § 243.4(j).

[13] The Federal Reserve and FDIC would also be able to continue to regularly assess a banking organization's resolvability through the supervisory process.

- The duplicative requirement of filing a separate IDI plan should be eliminated.
- The asset threshold for requiring living wills should be raised from $50 billion to an appropriate higher amount, and for foreign banking organizations, should be based on U.S. assets.
- Changes in the filing dates should be announced by the agencies well in advance and not, as in the past, weeks before a filing is due, and banking organizations should be provided with sufficient time to respond to new guidance or other feedback.
- The Federal Reserve and FDIC's living wills assessment criteria should be made public and subject to public notice and comment period before becoming final, consistent with the requirements of the Administrative Procedure Act.
- The FDIC should disclose its preferred strategy for resolving systemically important financial institutions under OLA to the public and disclose institution-specific preferred strategies to the institutions themselves.

Chapter 6

DERIVATIVES

Relevant Agencies

- CFTC
- FCA
- FDIC
- FHFA
- FRB
- OCC
- SEC

Chapter 6 – Derivatives

Title VII enacted beneficial reforms that have enhanced transparency and mitigated risks in the OTC derivatives market. The implementation of Title VII, however, was unduly complex, costly and over-engineered. Implementation issues have impeded U.S. access to global and regional markets, end-user access to funding and liquidity and efficient risk management. Addressing these issues can help promote U.S. competitiveness, job creation and economic growth, without undercutting Title VII's transparency and risk mitigation benefits.

A. Original Problem to be Remedied

Following the financial crisis, G20 members agreed to strengthen the regulation of OTC derivatives through five key reforms: clearing of standardized OTC derivatives through CCPs; reporting of OTC derivatives to trade repositories; where appropriate, trading of standardized OTC derivatives on exchanges or electronic trading platforms; higher capital requirements for non-cleared derivatives; and margin requirements for non-cleared derivatives.[1] Congress enacted these reforms in Title VII and charged the regulators listed in the sidebar with their implementation.

The regulators have now adopted rules implementing the vast majority of Title VII reforms:

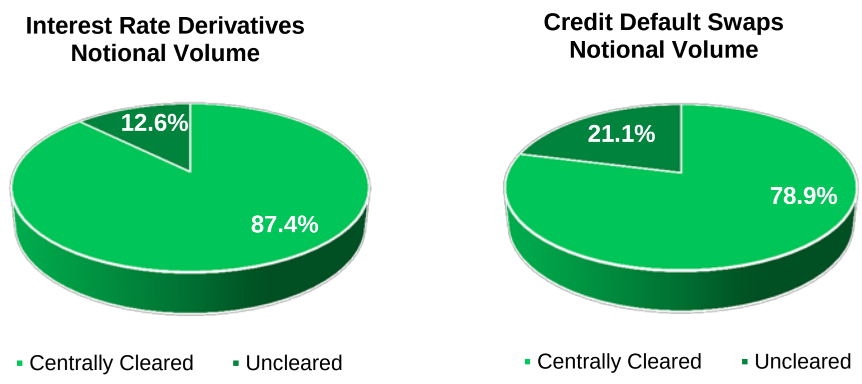
- All CFTC-regulated swaps, amounting to over 95% of the notional value of the OTC derivatives markets,[2] are now reported to trade repositories if a U.S. person or non-U.S. affiliate swap dealer is a party to the trade;
- 100% of all mandated interest rate and credit default swaps are centrally cleared, amounting to over 87% of the notional volume of OTC interest

[1] G20, Pittsburgh summit declaration (link) and Cannes summit final declaration (link).

[2] The OTC credit and equity derivatives regulated by the SEC as security-based swaps comprise less than 3% of outstanding notional amounts in the OTC derivatives markets. BANK FOR INT'L SETTLEMENTS, SEMI-ANNUAL OTC DERIVATIVES STATISTICS AT END-JUNE 2016 (Nov. 2016) (link). Unless otherwise stated, references to "swaps" in this Chapter also refer to security-based swaps.

rate derivatives and over 78% of the notional volume of index credit default swaps;[3]

Figure 10 – Interest Rate Derivatives and Credit Default Swaps Notional Volume



Source: ISDA, SwapsInfo Weekly Analysis (Apr. 7, 2017).

- Trading on CFTC-registered SEFs amounts to over 56% of the notional volume of OTC interest rate derivatives and over 74% of the notional volume of index credit default swaps;[4] and
- By September 1, 2017, new non-cleared swaps between financial entities will be secured by daily mark-to-market, or variation margin, preventing the buildup of unsecured exposure over time and thereby significantly mitigating systemic risk.

In addition, the SEC has proposed rules addressing each of the key Title VII reforms and finalized rules governing the reporting of security-based swaps and the registration and regulation of security-based swap dealers.

[3] INT'L SWAPS AND DERIVATIVES ASS'N, SWAPSINFO WEEKLY ANALYSIS (Apr. 7, 2017) (link). Interest rate derivatives and index credit default swaps make up over 80% of outstanding notional amounts in the OTC derivatives markets. BANK FOR INT'L SETTLEMENTS, SEMI-ANNUAL OTC DERIVATIVES STATISTICS AT END-JUNE 2016 (Nov. 2016) (link).

[4] INT'L SWAPS AND DERIVATIVES ASS'N, SWAPSINFO WEEKLY ANALYSIS (Apr. 7, 2017) (link).

B. Need for Rebalancing

With Title VII's reforms largely in place, it is now possible to evaluate the implementation of those reforms with a view to preserving aspects that have proved beneficial while minimizing rules that have unnecessary and undesirable consequences.

1. Title VII Implementation Issues Have Harmed U.S. Competitiveness and Fragmented Global Markets (Core Principles (c) and (d))

The OTC derivatives markets were historically among the most globally integrated of our financial markets. Before Title VII, U.S. firms traded abroad on a level playing field with non-U.S. competitors, and a diverse range of non-U.S. firms were willing to provide liquidity in the United States, often as part of their lending to U.S. firms. This global integration helped promote liquidity, reduce costs, and limit concentration of risks.[5]

Accordingly, international harmonization of derivatives reforms was a key objective of Congress, U.S. regulators, and their G20 counterparts. Despite this consensus, however, legislatures and regulators often did not agree on the details of implementation. Even in cases where regulators achieved a detailed agreement on a harmonized approach, different implementation schedules have created competitive disparities unfavorable to U.S. firms and markets.

The adverse impact of disparate rules has been exacerbated by the regulators' decision to apply Title VII extraterritorially. As enacted by Congress, Title VII does not apply extraterritorially except where non-U.S. activities present a direct and significant risk to the United States. But, as implemented by regulators, Title VII frequently applies extraterritorially to U.S. firms' foreign branches and affiliates and the non-U.S. market participants with whom they transact without meeting the direct and significant standard.

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[5] Derivatives end-users and investors have routinely emphasized the importance of global integration of the OTC derivatives markets. Letter from the U.S. Coalition for Derivatives End-users and European Association of Corporate Treasurers (July 11, 2013) (link), Letter from the Investment Company Institute and ICI Global (Aug. 21, 2013) (link) and Letter from the Coalition for Derivatives End-Users (Dec. 19, 2016) (link).

"As predicted, the CFTC's flawed swaps trading implementation has caused numerous harms, foremost of which is driving global market participants away from transacting with entities subject to CFTC swaps regulation. It has fragmented global markets into a series of distinct liquidity pools that are less resilient to market shocks and less supportive of global economic growth. It has unnecessarily impeded banks' financial risk hedging activities necessary for healthy extension of credit to the private sector."[8]

– J. Christopher Giancarlo, Acting Chair, CFTC

For example, if the foreign branch or guaranteed affiliate of a U.S. bank seeks to trade on a local swaps trading platform, then that trading platform typically must register with the CFTC as a SEF. The trading platform would then need to satisfy CFTC rules prescribing what execution methods it offers, even for trading that does not involve the U.S. bank. These extraterritorial U.S. requirements have generally been unacceptable to non-U.S. firms, leading most non-U.S. trading platforms to deny access to U.S. banks' foreign branches and guaranteed affiliates.[6] Implementation of the SEF registration requirement in October 2013 thus led to a sharp drop in U.S. dealers' share of trading in Europe of euro-denominated interest rate swaps from over 25% to less than 10%.[7]

Similar dynamics have been observed in reaction to other rules. For example, non-U.S. firms are often reluctant to trade with U.S. banks' foreign branches or affiliates lest those counterparties become subject to Title VII's margin rules—which apply even to trading between two non-U.S. persons, neither of which has a U.S. guarantee, if one of the parties happens to be swap dealer with a U.S. parent company.[9] Similarly, extraterritorial application of CFTC registration requirements has led most non-U.S. CCPs to limit or no longer permit U.S. participation.[10]

The resulting market fragmentation harms the U.S. economy and job creation, which is inconsistent with Core Principle (c)—fostering economic growth and vibrant financial markets. As noted by a broad coalition of corporate end-users of derivatives in response to a recent CFTC proposal,

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[6] Only two non-U.S. trading platform have registered as SEFs and only one additional non-U.S. trading platform has elected to rely on the CFTC's relief for qualifying non-U.S. trading platforms.

[7] INT'L SWAPS AND DERIVATIVES ASS'N, CROSS-BORDER FRAGMENTATION OF GLOBAL INTEREST RATE DERIVATIVES: SECOND HALF OF 2015 UPDATE (May 2016) (link). PricewaterhouseCoopers found that this liquidity fragmentation led to price divergence between U.S. and European markets equal to as much as four times the typical bid-ask spread. PricewaterhouseCoopers LLP, *Global financial markets liquidity study* 43–44 (Aug. 2015) (link).

[8] J. Christopher Giancarlo, Acting Chair, Transforming the CFTC (Mar. 30, 2017) (link).

[9] Extraterritorial application of Title VII's clearing rules has also been problematic. For example, clients in Australia and Hong Kong have curtailed their trading with U.S. banks' Australian and Hong Kong branches since the CFTC expanded its clearing mandate to cover local foreign currency-denominated interest rate swaps.

[10] For example, except in Singapore, no Asian CCP permits clearing by U.S. customers.

market fragmentation can "ultimately raise prices for Main Street consumers who rely on reasonably priced products and services and . . . hurt the standing of U.S. companies with foreign operations to compete globally."[11]

In principle, regulators could address these competitive disparities by allowing firms to comply with U.S. rules through substituted compliance with comparable non-U.S. rules. U.S. regulators stated their intention to take an outcomes-based approach to making the comparability determinations that are necessary to permit substituted compliance. In practice, however, they have failed to make these determinations in many key areas,[12] or they have imposed limitations that are antithetical to the very goal of substituted compliance, such as a stricter-rule-applies condition that effectively requires firms to satisfy both sets of rules.[13] Regulators' burdensome substituted compliance framework has not prevented the emergence of competitive disparities.

> "U.S. entities could be at a competitive disadvantage if non-U.S. entities determine that the burden and costs for obtaining permission for substituted compliance or having to comply with CFTC rules for which there are no foreign counterpart requirements outweigh the benefits of engaging in transactions with U.S. registered funds or non-U.S. funds that are deemed U.S. persons."[14]
>
> *– The Investment Company Institute and ICI Global*

Regulators have adopted or proposed to adopt additional requirements on non-U.S. firms doing business in the United States that extend U.S. regulation beyond those firms' trading with U.S. clients. For example, under CFTC staff guidance and SEC rules, a non-U.S. firm that trades with a non-U.S. client through personnel located in the U.S. must comply with a wide range of Title VII requirements. These personnel arrangements are important to the maintenance of global market liquidity across multiple time zones. Temporary relief or delays of these rules have been necessary so that

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[11] Letter from the Coalition for Derivatives End-Users (Dec. 19, 2016) (link).

[12] The only instance where regulators have recognized other jurisdictions' implementation of the G20 clearing, trading, margin or reporting mandates is the CFTC's recognition of Japanese margin rules. The CFTC has also recognized certain foreign regulations outside of the G20 mandates (e.g., EU documentation, portfolio reconciliation and portfolio compression requirements).

[13] For example, the CFTC and European Commission agreed to a "stricter-rule-applies" approach where exemptions from mandatory clearing exist in one jurisdiction but not in the other. CFTC, CROSS-BORDER REGULATION OF SWAPS/DERIVATIVES DISCUSSIONS BETWEEN THE [CFTC] AND THE EUROPEAN UNION – A PATH FORWARD (July 11, 2013) (link).

[14] Letter from the Investment Company Institute and ICI Global (Aug. 23, 2012) (link).

non-U.S. firms do not face further disincentives from creating jobs, investing and providing liquidity in the United States.[15]

2. Rules for Non-Cleared Swaps Go Beyond What is Necessary to Mitigate Risk, Unduly Impeding U.S. Job Creation and Economic Growth (Core Principle (c))

> "I am very concerned by recent press reports of remarks by unnamed Fed officials that the 10 day coverage period may be intentionally "punitive" in order to move the majority of trades into a cleared environment. Any punitive or arbitrary squeeze on non-cleared swaps will surely have consequences — mostly negative — for American businesses and their ability to manage risk. With tens of millions of Americans falling back on part-time work, it is not in our national interest to deter American employers from safely hedging commercial risk to free capital for new ventures that create full-time jobs. It is time we moved away from punishing U.S. capital markets and move toward rules designed to revive American prosperity."[16]
>
> *– J. Christopher Giancarlo, Commissioner, CFTC*

Title VII's mandatory clearing requirements have quite successfully increased central clearing. In addition, higher capital requirements now apply to non-cleared swaps, which provide a significant incentive for central clearing.

Nonetheless, the regulators, as part of an international regulatory working group, designed margin requirements for non-cleared swaps so as to further promote central clearing beyond what has occurred as a result of these already extensive measures.[17] In particular, they established initial margin[18] requirements for non-cleared swaps at levels required to address potential adverse market movements over a 10-day period, rather than the 5-day period typically required for cleared swaps—resulting in roughly 40% higher margin requirements. No rigorous empirical analysis informed this difference, even though market participants had raised significant concerns with the 10-day requirement.[19]

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[15] Notably, end users have indicated that they would generally seek to avoid trading with non-U.S. dealers using U.S. personnel if doing so would subject them to duplicative regulatory requirements. Letter from the Coalition for Derivatives End-Users (Mar. 10, 2014) (link).

[16] J. Christopher Giancarlo, Commissioner, Opening Statement at Open Meeting on Proposed Rule on Margin Requirements for Uncleared Swaps and Final Rule on Utility Special Entities (Sept. 17, 2014) (link).

[17] BASEL COMM. ON BANKING SUPERVISION AND INT'L ORGANIZATION OF SECURITIES COMMISSIONS, MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES (Mar. 2015) (link). The SEC has not yet finalized its margin rules for non-cleared security-based swaps.

[18] Initial margin is intended to collateralize the potential change in value of derivatives with a counterparty in default after the default occurs but before the non-defaulting counterparty can replace those derivatives. Under current rules, when a firm collects initial margin, it cannot re-use it to fund other aspects of its business.

[19] Objections were raised by asset managers commenting on a prior version of these rules in 2011, but ultimately were not addressed by the regulators. Letter from Joanne Medero, Managing Director, Blackrock, to the CFTC (July 11, 2011) (link); Letter from Douglas Hodge, Managing Director, PIMCO, to the CFTC (July 11, 2011) (link).

It is not obvious why these punitively higher margin requirements are necessary to incentivize central clearing, since Title VII already includes mandatory clearing requirements for suitable swaps. The only firms who are exempt from mandatory clearing are also exempt from margin requirements for non-cleared swaps. For firms subject to both requirements, the higher margin requirements for non-cleared swaps impose unnecessary costs, particularly since many non-cleared swaps are too customized or thinly traded to be clearable.

These costs are quite significant, requiring U.S. firms to lock up an estimated $315 billion in high-quality assets,[20] even with a $50 million threshold before initial margin requirements apply to a pair of counterparties together with their affiliates.[21] Much of these costs are ultimately borne by end-users.[22] These costs are in addition to the costs of increased capital and liquidity reserves U.S. banks must now hold for non-cleared swaps. These rules should instead be complementary, so that the aggregate amount of capital, liquidity reserves and margin requirements is well-calibrated against the risks of non-cleared swaps.[23]

U.S. regulators have exacerbated the adverse impact of this flawed margin regime by expanding the scope of firms subject to it relative to parallel non-U.S. rules. In particular, regulators in other jurisdictions recognized exceptions from both initial and variation margin requirements for firms that do not trade a significant amount of OTC derivatives. Such firms do not contribute to significant risk through their OTC derivatives activity but U.S. regulators have not recognized any such exception. This difference

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[20] Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840, 74,891 (Nov. 30, 2015).

[21] This threshold was adopted by an international regulatory working group on the basis of a quantitative impact study that had serious methodological flaws and was misunderstood and inconsistently construed by firms contributing data to the study. SIFMA provided detailed comments on the study at the time, but regulators failed to address them. Letter from SIFMA (Mar. 15, 2013) (link).

[22] Letter from the Coalition for End-Users (Dec. 2, 2014) (link).

[23] There has generally been a failure to analyze the cumulative impact of Title VII and enhanced prudential requirements. Consequently, these rules frequently work at cross-purposes (e.g., leverage ratio requirements increase the cost of central clearing, and margin requirements reduce the availability of high-quality liquid assets) or are duplicative (margin requirements for non-cleared swaps and heightened capital requirements for those same swaps). SIFMA's further comments on capital and liquidity requirements are set forth in Chapters 2 and 3.

places U.S. firms at a competitive disadvantage when they attempt to trade with non-U.S. clients in this category. It also makes it difficult for smaller U.S. investment firms to invest or hedge using swaps[24] and inhibits the use of swaps to hedge exposures in connection with securitization activities.

U.S. regulators have also adopted stricter deadlines for when firms must collect required margin than the deadlines that apply in foreign jurisdictions. This difference also puts U.S. firms at a competitive disadvantage, since it makes it more difficult for non-U.S. clients to post non-cash collateral or trade with U.S. firms across multiple time zones.

The U.S. banking regulators uniquely have imposed initial margin requirements on inter-affiliate transactions, in addition to variation margin requirements. Doing so inhibits centralized, group-wide risk management and significantly increases the amount of high-quality assets locked up under the margin rules, beyond the level necessary for risk mitigation. The CFTC, in turn, has exempted inter-affiliate transactions from initial margin requirements and mandatory clearing requirements—but only if the transacting affiliates collect initial margin or centrally clear their swaps with third parties, even in non-U.S. jurisdictions where Title VII's cross-border framework would not otherwise require them to do so.

Required initial margin levels are also higher because existing standards for imposing mandatory clearing and trading rules to amended or new swaps unnecessarily inhibit measures to reduce bilateral credit risk. For example, amendments to extinguish current market credit exposure or new swaps executed to reduce potential future credit exposure often trigger these rules, which effectively prohibits these risk-reducing trades.

Recalibrating margin and clearing rules to be more risk-sensitive and work in tandem with enhanced prudential requirements would unlock significant resources for U.S. lending, investment and job creation, without exposing the U.S. financial system to undue risk. During the 2003 to 2012 period

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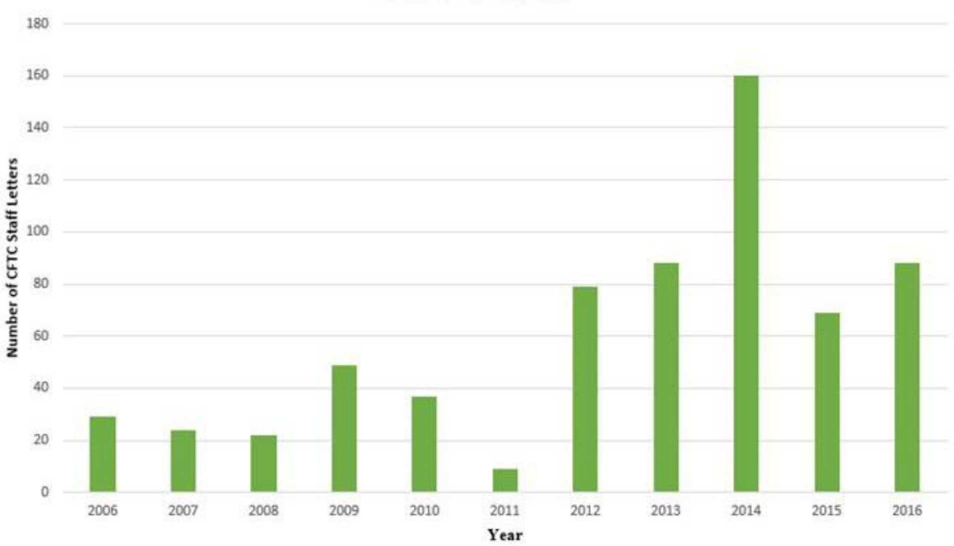
[24] *Impact of G-20 Clearing and Trade Execution Requirements: Hearing Before the H. Subcomm. on Commodity Exchanges, Energy and Credit*, 115th Cong. (June 14, 2016) (statement of Luke Zubrod, Director, Chatham Financial) (link).

before these rules were implemented, derivatives are estimated to have boosted U.S. real GDP by about $3.7 billion each quarter.[25]

3. The Title VII Implementation Process Lacked Adequate Transparency, Accountability and Coordination (Core Principle (g))

These issues were the result of a Title VII implementation process that was rushed and chaotic. The rule rollout was punctuated by significant problems created largely by the CFTC's unnecessarily accelerated and inadequately deliberative rulemaking process. The CFTC routinely resorted to guidance and staff no-action letters to modify problematic new rules and delay unachievable compliance dates. As shown in Figure 11, in the six years preceding Title VII implementation (2006-2011), CFTC staff averaged approximately 30 letters per year, while in 2014 alone CFTC staff issued 160 letters, mostly to address issues occasioned by the CFTC's Title VII rollout.

Figure 11 – CFTC Staff Letters



Source: CFTC, Letters Archive (link).

The CFTC staff often released these letters at the very last minute, and, as staff actions, the letters did not follow rulemaking processes.[26] The

[25] APANARD PRABHA ET AL., DERIVING THE ECONOMIC IMPACT OF DERIVATIVES, MILKEN INSTITUTE 1 (Mar. 2014) (link).

resulting regulatory patchwork lacked a cohesive policy framework and had no foundation in meaningful cost-benefit analysis.

As a result of its inadequate deliberation, not only did the CFTC adopt flawed cross-border rules and margin rules but it also adopted:

- SEF trading rules that codify particular incumbent trading practices and lack consistency with the statutory framework for SEF regulation;
- Trade reporting rules that are highly complex and inconsistent with other U.S. and non-U.S. reporting rules, which lead firms to report data that is often not useful or, at times, impairs market liquidity; and
- Extensive swap dealer risk management and governance rules, including for firms already subject to OCC and/or Federal Reserve oversight.

Despite efforts to harmonize, CFTC and SEC business conduct requirements will require counterparties to use different documentation for economically similar products, without providing any meaningful additional protections. The SEC also will require firms to report additional data fields that no other regulator, including the CFTC, requires. Proposed CFTC and SEC capital requirements continue to incorporate differences from each other and other regulators' capital requirements in ways that are not warranted by differences in circumstances or other considerations.

C. Proposed Recommendations

Addressing the issues described above does not require Congress to roll back Title VII or U.S. regulators to abandon G20 principles. It will, however, require regulators to focus on how Title VII rulemaking affects economic growth, jobs, and competitiveness, in addition to risk mitigation and market transparency.

Below SIFMA sets forth recommendations for how best to achieve these objectives without necessitating legislative action. The regulators should act expeditiously on these recommendations. The SEC should also re-propose its Title VII rules, both already final rules and those still only

(continued….)

[26] Hester Peirce, *Regulating through the Back Door at the [CFTC]* (Mercatus Working Paper, Nov. 2014) (link).

proposed, to take into account new rules and guidance from the other regulators. The SEC should also adopt permanent relief tailoring the application of existing securities laws to security-based swaps.

1. Title VII Cross-Border Framework

Regulators should modify Title VII's cross-border framework to reverse market fragmentation by creating a level playing field for U.S. and non-U.S. firms, as follows:

- **Tailor the extraterritorial application of Title VII to foreign branches and affiliates so that U.S. firms can effectively compete in non-U.S. markets**

  Title VII should not apply extraterritorially to U.S. firms' foreign branches or affiliates where existing regulation already protects against significant risk flowing back to the United States:

  - Swap dealer registration should not apply to a U.S. firm's non-U.S. affiliate on the basis of trading with non-U.S. counterparties if the U.S. firm's non-U.S. affiliate is regulated in a G20 jurisdiction or otherwise subject to Basel-compliant capital standards, regardless of whether the affiliate is guaranteed by its U.S. parent. This approach would promote U.S. competitiveness abroad while still ensuring that U.S. firms cannot use offshore affiliates to conduct unregulated swaps trading.

  - Non-U.S. swap counterparties, trading platforms and CCPs should not be required to register as swap dealers, SEFs or derivatives clearing organizations, respectively, as a result of doing business with a U.S. firm's foreign branch or affiliate (guaranteed or not).[27] This approach would remove the incentives for foreign liquidity providers, trading platforms, and CCPs to refuse access to U.S. firms, while allowing existing prudential regulation to address any risks faced by U.S. firms trading abroad.

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[27] Also, like in the futures markets, U.S. customers should be permitted to access non-U.S. swaps trading platforms and CCPs through U.S. brokers or comparably regulated non-U.S. brokers without subjecting the trading platform or CCP to U.S. registration. Regulation of their brokers would serve to protect U.S. customers, while allowing them to access liquidity abroad.

- Since they are already subject to comprehensive U.S. prudential supervision at the legal entity or consolidated level, or both, U.S. firms' foreign branches and affiliates, guaranteed or not, should not be subject to Title VII's mandatory clearing, mandatory trading, margin, or reporting rules when they trade with non-U.S. firms, at least in other G20 or similarly highly regulated jurisdictions.[28] This approach will help ensure that U.S. firms' foreign branches and affiliates can transact on a level playing field with local competitors and each other.

- **Promote cross-border market access through more robust substituted compliance**

  In any remaining instances where U.S. rules overlap with rules of another jurisdiction that has a comprehensive regulatory framework for derivatives consistent with G20 or other internationally recognized principles, then the transacting parties—including U.S. firms and their foreign branches and affiliates—should be able to transact under the rules of that other jurisdiction, without any stricter-rule applies condition or other limits on substituted compliance. This more rigorous substituted compliance framework would help reverse market fragmentation.

- **Remove undue impediments to the position of the United States as a global financial center**

  The CFTC and SEC should undo Title VII guidance and rules that discourage non-U.S. firms from investing, trading or creating jobs in the United States:

  - To encourage firms to hire U.S. front-office personnel and promote global market liquidity, Title VII rules should not apply to a swap between non-U.S. firms or between a non-U.S. firm and a foreign branch or affiliate of a U.S. firm on the basis that U.S.-located

[28] At a minimum, if these rules continue to apply to U.S. firms' foreign branches or affiliates outside such highly regulated jurisdictions, a limited exception should apply to foreign branch or affiliate trading activity with non-U.S. firms that does not exceed a *de minimis* proportion of the U.S. group's overall trading activity. This exception would build on an existing CFTC exception, which recognized that, although trading in emerging market branches is not a significant source of risk, it is an integral component of U.S. banks' global businesses.

personnel arrange, negotiate or execute the swap. The participation of U.S. personnel does not create risks justifying the imposition of Title VII requirements to these otherwise non-U.S. swaps.

- The SEC intends to require a non-U.S. security-based swap dealer to provide a certification and legal opinion regarding SEC access to its books and records and ability to conduct on-site examinations. The SEC also intends to require all security-based swap dealers to conduct background checks regarding non-U.S. employees. These rules cover more than just the business that these firms conduct in the United States, which results in conflicts with foreign laws. To encourage non-U.S. firms to trade in the U.S. markets, the SEC should limit or eliminate these requirements.[29]

- If a non-U.S. dealer registers with the CFTC or SEC because it enters into swaps with U.S. persons, it also becomes subject to U.S. reporting rules for its swaps with non-U.S. persons. Those swaps have a very limited U.S. nexus, but reporting them to U.S. regulators often violates foreign laws. While the CFTC has granted relief from these reporting rules for a non-U.S. swap dealer that is part of a non-U.S. corporate group, the CFTC should expand this relief to all non-U.S. swap dealers and make it permanent. The SEC should adopt the same relief. This relief would encourage non-U.S. firms to trade in U.S. markets.

2. Margin and Clearing Requirements

The regulators should, working together and with their international counterparts as appropriate,[30] recalibrate margin and clearing requirements so as to unlock resources for lending and investment by focusing the requirements solely on what is appropriate to mitigate risk, as follows:

- **Adjust the level of required initial margin to be risk-sensitive and appropriate to the reduction of systemic risk**

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[29] The CFTC adopted an exception to its parallel certification for instances where blocking, privacy or secrecy laws apply. The CFTC has also provided relief from background check rules for non-U.S. employees who do not trade with U.S. counterparties.

[30] Since certain problematic aspects of the margin rules are incorporated into international standards, the regulators should seek to modify those standards. The SEC margin requirements for non-cleared security-based swaps are not yet final.

Initial margin levels for non-cleared swaps should be made consistent with initial margin levels for similar cleared swaps, and all appropriate risk offsets should be recognizable when calculating initial margin.[31]

- **Increase the $50 million maximum initial margin threshold**

  Regulators should conduct a further review to consider increasing the $50 million initial margin threshold.

- **Tailor the scope of covered market participants to focus on the most significant sources of risk**

  Margin requirements should only apply to dealers and the most significant non-dealer market participants—not all firms engaged in investing or trading activity. An appropriate *de minimis* exception should also apply to trading with counterparties located in jurisdictions lacking legally-enforceable netting regimes, so that U.S. firms are not blocked from doing business in those jurisdictions.

- **Set realistic deadlines for collecting margin**

  Regulators should revise the deadline for collecting margin to account for logistical and operational considerations that impact the margin transfer process.[32]

- **Remove impediments to effective risk management by exempting inter-affiliate swaps**

  Inter-affiliate swaps should be exempt from initial margin, mandatory clearing and mandatory trading requirements, so long as they are part of a centralized risk management program and remain subject to variation margin requirements.

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[31] U.S. regulations increase initial margin requirements unnecessarily by preventing firms from recognizing offsetting risks across derivatives that happen to be regulated by a different regulator (the CFTC, SEC or Prudential Regulators). This basis for not recognizing *bona fide* risk offsets lacks a rational policy justification and imposes unnecessary costs on U.S. firms. Regulators should remove these artificial limits so that firms have a greater ability to portfolio margin non-cleared transactions with related risk profiles.

[32] Separately, to avoid exacerbating a potential crisis, counterparties should have additional time to satisfy increases in initial margin resulting from a recalibration of margin requirements during a period of increased market stress.

- **Permit efforts to reduce bilateral credit risk**

  Mandatory clearing and trading requirements should not apply when firms enter into or amend non-cleared swaps to reduce their credit risk to each other, either bilaterally or through multilateral exercises.

3. Other Title VII Requirements

Acting CFTC Chair Giancarlo has begun a new initiative to conduct an agency-wide review of CFTC rules, regulations and practices to make them simpler, less burdensome and less costly, which SIFMA strongly supports. As part of this initiative, SIFMA encourages the CFTC to identify opportunities to simplify, harmonize and streamline SEF trading, trade reporting, business conduct and capital requirements.[33] The SEC should engage in a similar initiative before implementing its parallel rules.[34]

[33] Specific rule areas the CFTC should examine are: required execution methods on SEFs; treatment of block trades and package trades; the "made available to trade" process; SEF impartial access requirements; SEFs' treatment of swaps rejected from clearing; required data fields and data formats; confirmation data reporting; block trade thresholds and delays; pre-trade mid-market marks; scenario analysis; daily marks; chief compliance officer reports; pre-trade recordkeeping requirements (particularly voice recording requirements); requirements relating to the format and searchability of records; clearing/trading conflicts of interest requirements; CFTC-specific risk management and business continuity rules applicable to swap dealers subject to oversight in those areas by other U.S. regulators; and CFTC capital requirements applicable to swap dealers subject to Federal Reserve, SEC or foreign capital supervision.

[34] The SEC's rules also raise some unique issues not raised by the CFTC's rules, such as a requirement for the non-reporting party to obtain and provide unique identifier codes and a requirement for data repositories to publish data to the public immediately upon receipt, even for block trades.

Chapter 7

INCENTIVE COMPENSATION

Relevant Agencies

- FDIC
- FHFA
- FRB
- NCUA
- OCC
- SEC

Chapter 7 – Incentive Compensation

A. Original Problem to be Remedied

Overview. Consistent with the Core Principles, Section 956 of the Dodd-Frank Act should be repealed. Pending repeal, the recently proposed regulations under Section 956 should be withdrawn and a finding should be made that no further guidelines or regulations are necessary. Section 956 was largely duplicative of regulatory efforts already underway when it was enacted, was not clearly supported by any particular policy concern articulated by Congress and has proven to be unnecessary during the intervening seven years in which final rules have not been adopted.

Congress enacted Section 956 in the immediate aftermath of the financial crisis. Despite limited legislative history, Section 956 appears to be grounded in policy concerns about questionable links between certain incentive compensation practices at financial institutions and inappropriate risk-taking at those institutions that some have argued contributed to the financial crisis. There were no legislative findings to support these links, so ultimately Section 956 reflects a mindset that regulatory judgment is superior to the business judgment of boards, senior management and control functions in structuring incentive compensation programs and assessing their risk profile.

What is Section 956? Section 956 requires six federal agencies to jointly issue guidelines or regulations that prohibit incentive compensation that they determine encourages inappropriate risks by covered financial institutions with assets of at least $1 billion by providing individuals with excessive compensation or compensation that could lead to material financial loss to the institution. If and to the extent the agencies determine incentive compensation at covered financial institutions encourages inappropriate risk-taking, Section 956 requires the agencies to implement guidelines or regulations that are comparable to Section 39(c) of the Federal Deposit Insurance Act, which has been in effect since 1991, and which requires the federal banking agencies to establish standards prohibiting certain types of unsafe and unsound compensation arrangements. The agencies were tasked with doing so for *all* regulated financial services firms above a minimum size threshold, while other companies, including unregulated firms, that compete for much of the same talent are not subject to regulation.

What is the current status of Section 956? In the nearly seven years since Section 956 was enacted, the agencies have not issued final guidelines or regulations under Section 956. They issued a proposed rule in 2011 and then five years later in 2016, a wildly different reproposed rule.[1] It seems clear that the agencies are having difficulty determining what, if anything, they need to do under Section 956 that they have not already done.

Section 956 is a solution in search of a problem. Since Section 956 was enacted, there have been, and continue to be, serious questions about the problem it is supposed to address.

First, by the time Section 956 was enacted, the federal banking agencies had already adopted regulatory measures to address concerns that incentive compensation structures might lead to inappropriate risk taking. In October 2009, the Federal Reserve introduced proposed guidance that set forth principles for sound incentive compensation programs at banking organizations. In June 2010, shortly before the Dodd-Frank Act was enacted in July, the Federal Reserve, the OCC and the FDIC jointly adopted the interagency "Guidance on Sound Incentive Compensation Policies" issued in 2010, which remains applicable today.

The 2010 interagency guidance is a principles-based approach, which promotes effective incentive compensation arrangements and related corporate governance practices without being overly prescriptive. While SIFMA recognizes that it is not without its challenges, it generally is consistent with the Core Principles and the requirement that regulation should be appropriately tailored and rationalized and permit businesses operating in the United States to be competitive. Namely, it reflects an understanding that any oversight of incentive compensation must be dynamic and flexible so that it can be reasonably tailored in its application to allow firms to take appropriate business risks, compete for talent and reward good performance; cover only those individuals who could expose an institution to the risk of material loss; and cover only those incentive compensation programs that could incentivize inappropriate risk.

[1] DAVIS POLK & WARDWELL LLP, INCENTIVE COMPENSATION FOR FINANCIAL INSTITUTIONS: REPROPOSAL (May 2, 2016).

Under the 2010 interagency guidance, each covered financial institution must determine which individuals and programs are covered, based on their deep knowledge of their own business model, supervised by the agency which is familiar with the institution and which has a horizontal perspective on the broader industry. This is effective because it allows the design of compensation programs that are appropriate for the institution, rather than those that would result from the application of bright-line rules that cannot appropriately take into consideration each institution's size, population of employees and business model. The principles-based approach of the 2010 interagency guidance was selected specifically to avoid the shortcomings of a one-size-fits-all approach. Indeed, in the adopting release for the 2010 interagency guidance, the Federal Reserve, the OCC and the FDIC explicitly recognized that imposing an overly prescriptive framework or a "single formulaic approach" could increase, rather than decrease, risk.[2]

Second, although a theoretical link between incentive compensation and excessive risk-taking has been suggested, there is no evidence in the legislative history of Section 956 supporting the notion that incentive compensation regulations were needed for the broad range of institutions covered by Section 956 (depositary institutions, broker-dealers, credit unions, investment advisors, Fannie Mae, Freddie Mac). A Congressional Research Service report on July 29, 2010, nine days after the Dodd-Frank Act was enacted, stated that although initiatives to regulate compensation "were significantly premised on the widely held belief that large financial firm incentive pay structures significantly contributed to excessive risk taking," there was a lack of consensus as to whether that premise is true. The report cited "to a major academic study [that] ha[d] raised questions about the premise undermining the purported reasoning of Section 956."[3]

In light of the persistent questions regarding a need for Section 956, it is not surprising that the agencies have found it difficult to issue final guidance or regulations under Section 956. To date, the agencies have been unable to identify any link between incentive compensation and excessive risk. In

[2] Dep't. of the Treasury, Guidance on Sound Incentive Compensation Policies, Docket No. OP-1374 20 ("use of a single, formulaic approach likely will provide at least some employees with incentives to take imprudent risks").

[3] BAIRD WEBEL, CONG. RESEARCH SERV., R41350, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: ISSUES AND SUMMARY (July 29, 2010), citing Rüdiger Fahlenbrach, René M. Stulz and Rene M. Bank, *CEO Incentives and the Credit Crisis* (Charles A. Dice Center Working Paper No. 2009-13, July 27, 2009).

fact, in an attempt at a cost-benefit analysis in the adopting release for the 2016 reproposed rule, the SEC stated that "there are conflicting studies as to the link of compensation to risk-taking" and pointed to multiple studies that take the position that compensation structures were not responsible for dysfunctional risk-taking and performance of financial institutions during the crisis.[4] Numerous studies in addition to those cited by the SEC reach similar conclusions.[5]

B. Need for Rebalancing

The repeal of Section 956 and the withdrawal of the 2016 reproposed rule are appropriate because the regulation of financial institution incentive compensation, as it has been applied after the financial crisis, already addresses the concerns raised by Section 956. No further guidelines or regulation are necessary, and there is no need to rebalance or expand the current regulatory regime. There is an existing proposal to repeal Section 956 in the Financial CHOICE Act, a draft of which has been released by the House Financial Services Committee, which SIFMA supports. Pending repeal, the 2016 reproposed rule should be withdrawn and a determination should be made that no guidelines or regulations under Section 956 are necessary, given that the 2010 interagency guidance is appropriate in scope and substance.

1. Section 956 is Unnecessary and Counterproductive (Core Principle (f))

Section 956 is inconsistent with the Core Principles of eliminating duplicative or unnecessary laws and regulations and making laws and

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[4] Rüdiger Fahlenbrach, Robert Prilmeier & René M. Stulz, *This Time is the Same: Using Bank Performance in 1998 to Explain Bank Performance During the Recent Financial Crisis* (Oct. 2011) (banks performing poorly tied to leverage, not compensation); Ing-Haw Cheng, Harrison Hong and Jose A. Scheinkman, *Yesterday's Heroes: Compensation at Financial Firms*, J. OF FINANCE 70, 839-879 (2015) (examining the link between managerial pay and risk taking in the financial industry, the paper builds upon efficient contracting theory to predict that managers in companies facing greater amounts of uncontrollable risk would require higher levels of compensation.).

[5] John Core & Wayne Guay, *Is there a Case for Regulating Executive Pay in the Financial Services Industry?* (Jan. 25, 2010) (the case for additional regulation does not rely on "evidence or careful analysis as to why existing compensation practices are flawed (since there is little clear evidence that arrangements are systematically flawed).").

regulations effective and efficient. As weak as the case was for Section 956 in the first place, later events make it overwhelmingly clear that it is unnecessary and counterproductive. Specifically, reasons Section 956 should be repealed include that financial sector compensation standards have changed following the financial crisis, which obviates the need for additional regulation, the existing regulatory system is working and any further regulation could lead to talent drain, adversely impacting safety and soundness.

Industry standards have changed. Financial firms have made notable progress since 2008 in revising the structure of incentive compensation programs to address concerns of inappropriate risk-taking. Accordingly, Section 956, if it ever made sense as a policy matter, no longer addresses a valid policy concern.

The progress financial firms have made in revising their compensation practices to address risk concerns has been acknowledged by the agencies, and on a global level by the Financial Stability Board, and also been widely reported by the financial industry and consultants. Key developments relate to the design of compensation and enhanced involvement by risk control functions in relation to compensation.

In October 2011, one year after the 2010 interagency guidance was promulgated, the Federal Reserve, in its horizontal review report on incentive compensation practices at 25 large, complex banking organizations, concluded that these organizations "have made significant progress toward enhancing their incentive compensation arrangements, in ways that provide appropriately balanced incentives to take risks" through incentive compensation design and changing risk-management processes and controls.[6] Five years later, in the 2016 adopting release, the agencies provided an updated report on continued progress noting "incentive-based compensation arrangements at banking organizations have improved significantly," and highlighted improvements in the efficacy of control functions' oversight of compensation governance and design, noting such programs extended deeply into covered institutions, and not just at senior executive levels.[7] The Financial Stability Board reached similar

[6] FED. RESERVE, INCENTIVE COMPENSATION PRACTICES: A REPORT ON THE HORIZONTAL REVIEW OF PRACTICES AT LARGE BANKING INSTITUTIONS (Oct. 2011).

[7] The agencies further stated that "risk control functions had become more effective, and "frequently play an increased role in the design and operation of incentive-based (….continued)

91% of Institute for International Finance member survey respondents had an average vesting period for variable compensation of three years or more, over 90% had risk-adjustment provisions in their variable compensation.[10]

– IIF & Oliver Wyman Joint Reports from 2011 and 2013

Changes to incentive compensation programs since 2008 include: longer term performance measures, decreased use of leverage, increased risk-adjusting of incentive compensation, increased involvement of risk functions in all aspects of incentive compensation, and increased clawback and forfeiture requirements.[11]

– The Clearing House, 2015 report of 16 financial institution members to the Federal Reserve

100% of U.S. banks with assets over $50 billion had clawback policies, more than 80% had forfeiture provisions and approximately 70% had post-vesting stock holding requirements.[12]

– Meridian Compensation Partners, 2015 report on data from banks with more than $10 billion in assets

conclusions in a series of post-financial crisis reports, including most recently a 2015 review of 77 banking institutions.[8] Further evidence of financial institutions effectively evolving their compensation practices has been reported by trade groups and consulting firms.[9]

Existing regulatory system is working. Regulators have already taken actions to address any potentially problematic incentive compensation issues and the existing regulatory framework is working well. In addition to the principles-based 2010 interagency guidance, further regulatory action to address compensation at financial institutions includes FHFA's adoption of final compensation rules in 2014 under the Federal Housing Enterprises Safety and Soundness Act; the SEC's adoption of Regulation S-K Item 402(s) in 2009, requiring disclosure by public registrants of the relationship of risks to compensation policies and practices to the extent they are "reasonably likely to have a material adverse effect on the registrant," which has triggered board of director level review of compensation

(continued….)

compensation, and institutions have begun to build out frameworks to help validate the effectiveness of risk adjustment mechanisms." Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670, 37,676 (June 10, 2016).

[8] FINANCIAL STABILITY BD., IMPLEMENTING THE FSB PRINCIPLES FOR SOUND COMPENSATION PRACTICES AND THEIR IMPLEMENTATION STANDARDS (Nov. 10, 2015); FINANCIAL STABILITY BD., IMPLEMENTING THE FSB PRINCIPLES FOR SOUND COMPENSATION PRACTICES AND THEIR IMPLEMENTATION STANDARDS (Nov. 4, 2014). The FSB reports have highlighted the increased role of control functions in relation to compensation, noting that "significant banks have strengthened risk management processes and governance structures, including a more prominent and formalized role for the risk function in decisions regarding the alignment of compensation with both ex ante risk and ex post performance."

[9] INSTITUTE OF INT'L FINANCE & OLIVER WYMAN, COMPENSATION REFORM: EMBEDDING GLOBAL STANDARDS (2013); FINANCIAL STABILITY BD., FSB PRINCIPLES FOR SOUND COMPENSATION PRACTICES AND THEIR IMPLEMENTATION STANDARDS (Nov. 4, 2014); Meeting between the Clearing House and the Fed. Reserve, Docket No. R-1410 (Sept. 14, 2015); MERIDIAN COMPENSATION PARTNERS, EXECUTIVE COMPENSATION IN THE BANKING INDUSTRY – EMERGING TRENDS FOR BEST PRACTICES 2014–2015 (June 22, 2015).

[10] INSTITUTE OF INT'L FINANCE & OLIVER WYMAN, COMPENSATION REFORM: EMBEDDING GLOBAL STANDARDS (2013).

[11] Meeting between the Clearing House and the Fed. Reserve, Docket No. R-1410 (Sept. 14, 2015).

[12] MERIDIAN COMPENSATION PARTNERS, EXECUTIVE COMPENSATION IN THE BANKING INDUSTRY – EMERGING TRENDS FOR BEST PRACTICES 2014–2015 (June 22, 2015).

programs below the executive officer level;[13] and the CFPB's adoption of Regulation Z in 2013, which was specifically aimed at mortgage lending practices and prohibits loan originators from being paid based on the "term of a transaction" or the terms of multiple transactions.[14]

Since the 2010 enactment of Section 956, there have been no findings that either the institutions subject to the 2010 interagency guidance require further regulation or that the financial institutions that are not subject to the 2010 interagency guidance have risk profiles or compensation practices that pose the type of risks that Section 956 was meant to address.[15] The effectiveness of current regulation is demonstrated by the evolution of financial institution compensation practices since 2008, including by tying a greater portion of incentive compensation to long term performance.

Over-regulation could lead to talent drain and impact safety and soundness. Burdensome over-regulation that could be imposed under Section 956, as evidenced by the 2016 reproposed rule, could adversely impact safety and soundness at financial institutions by causing talent drain and transfer from regulated financial institutions to unregulated entities and businesses outside of the financial sector or country. The market for talent is highly competitive, and incentive compensation is a critical recruitment and retention tool. Financial institutions compete for personnel within the larger financial services industry, including with private equity firms, with international financial institutions whose operations are not subject to similar regulation and with other sectors of the economy that attract employees in key enterprise control functions. The risk of talent drain is

> "Big U.S. banks are already struggling to keep top talent from decamping for Silicon Valley or hedge funds. [The] proposed new rules on banker pay aren't likely to help."[16]
>
> *– New Rules Curbing Wall Street Pay Proposed, Wall Street Journal*

[13] Proxy Disclosure Enhancements, 74 Fed. Reg. 68,333 (Dec. 23, 2009).

[14] Loan Originator Compensation Requirements Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 11,279 (Feb. 15, 2013). Under Regulation Z, the definition of "term of a transaction" includes "any right or obligation of the parties to a credit transaction" and examples include that a mortgage broker cannot receive compensation based on the interest rate of a loan or the fact that the loan officer steered a consumer to purchase required title insurance from an affiliate of the broker.

[15] For example, the SEC was unable to make findings affirmatively linking risk and compensation in the preamble to the 2016 reproposed rule. Recent findings of the FSB/IOSCO Roundtable (Apr. 6, 2017) indicate asset managers do not contribute to financial instability since the use of balance sheet assets and leverage is limited. This is also addressed in the SIFMA 2016 Comment Letter on the 2016 reproposed rule.

[16] Donna Borak, Andrew Ackerman & Christina Rexrode, *New Rules Curbing Wall Street Pay Proposed*, WALL ST. J. (Apr. 22, 2016) (link).

> "This year, 26.28% of students surveyed chose…banks or global financial institutions – down from 37.5% in 2010 (down 30% since 2010)."[19]
>
> *– Wall Street Isn't What It Used to Be, Business Insider*

real and has been covered frequently in the press in recent years.[17] The SEC acknowledged in its adopting release for the 2016 reproposed rule that overregulation of compensation could "result in losses of managerial talent that may migrate from covered institutions to firms in different industries or abroad."[18]

2. The 2016 Reproposed Rule is Overly Prescriptive and Irrational (Core Principle (f))

SIFMA is particularly concerned with the 2016 reproposed rule. It is fatally flawed and inconsistent with the Core Principles, as it further burdens institutions that are already subject to prudential regulation and would impose strict mandates on other entities covered by Section 956 without evidence that regulatory oversight of their incentive compensation programs is necessary.[20] The further deficiencies of the 2016 reproposed rule are laid out in numerous comment letters to the agencies,[21] which provide the

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[17] Rob Copeland & Daisy Maxey, New Wall Street Pay Rules a Win for Hedge Funds, Mutual Funds, WALL ST. J. (Apr. 21, 2016,); Nathaniel Popper, Wall St. Regulators Propose Stricter Pay Rules for Bankers, NY TIMES (Apr. 21, 2016), Christina Rexrode, Justin Baer & Rachel Louise Ensign, One Expected Casualty of New Compensation Rules: Banker Bonuses, WALL ST. J. (Apr. 21, 2016); Donna Borak, Andrew Ackerman & Christina Rexrode, New Rules Curbing Wall Street Pay Proposed, WALL ST. J. (Apr. 22, 2016); Portia Crowe & Andy Kiersz, Wall Street isn't what it used to be, BUSINESS INSIDER (June 22, 2016).

[18] Incentive-Based Compensation Arrangements, Exchange Act Release No. 34-77776, 355 (May 6, 2016).

[19] Portia Crowe & Andy Kiersz, *Wall Street Isn't What It Used to Be*, Business Insider (June 22, 2016) (link).

[20] In particular, the 2016 reproposed rule would be highly prescriptive and would micromanage financial institutions' incentive compensation instead of allowing dynamic regulation based on safe and sound compensation principles that would provide firms and regulators with the flexibility to address individual circumstances. The agencies have not addressed how these prescriptive rules were intended to improve upon, or even coexist with, the existing principles-based guidance.

[21]Comment letter on 2016 reproposed rule from SIFMA (July 22, 2016); Comment letter on 2016 reproposed rule from American Bankers Association (July 22, 2016); Comment letter on 2016 reproposed rule from National Financial Services LLC (July 21, 2016); Comment letter on 2016 reproposed rule from The Risk Management Association (July 20, 2016). Several of the comment letters note the 2016 reproposed rule exceeds Section 956 statutory mandate of adopting regulations consistent with FDIA Section 39. Comment letter on 2016 reproposed rule from SIFMA (July 22, 2016); Comment letter on 2016 reproposed rule from Financial Services Roundtable (July 22, 2016); Comment letter on 2016 reproposed rule from The Clearing House (July 22, 2016). The only agency to (….continued)

necessary basis for determining that the 2016 reproposed rule should be withdrawn immediately, regardless of whether Section 956 is repealed.

In connection with the withdrawal, the agencies should make a finding that no guidelines or regulations under Section 956 are required. The agencies should find that the 2010 interagency guidance, while not without flaws and potential drawbacks for financial institutions, strikes an appropriate balance between protecting institutional integrity and ensuring the stability of financial institutions and a financial system that can be effective and agile. The 2010 interagency guidance has done a good job of regulating incentive compensation. There is no evidence that additional regulation would be more effective in protecting institutional or system-wide safety and soundness, and good reason to think any additional regulation would be counterproductive. The agencies should also issue an accompanying statement consistent with the discussion above regarding the need to repeal Section 956. The agencies' withdrawal statement should explain why the evidence that was submitted during the comment process establishes that the statute and its regulatory regime sweep too broadly, why the industry standards that have developed since the financial crisis regarding compensation program design and effective risk-management and controls render further rulemaking unnecessary, and, that having duplicative and unnecessary rulemaking is directly inconsistent with the Core Principles.

C. Proposed Recommendations

- Repeal the Dodd-Frank Act Section 956
- Pending repeal of Section 956, direct the agencies to withdraw the 2016 reproposed rule and simultaneously make a finding that the 2010 interagency guidance is sufficient in scope and substance and that no

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(continued….)

attempt a cost-benefit analysis of the 2016 re-proposed rule, the SEC, was unable to complete its analysis, suggesting the 2016 re-proposed rule would present litigation risk if the agencies were to adopt it. This is in part because Section 956 did not take into account the feasibility, costs or benefits of regulating incentive compensation across the financial services industry.

> further guidelines or regulations under Section 956 are required to meet the directives of Section 956.[22]

* * *

The focus of this position paper is Section 956 but SIFMA believes that a number of the other the Dodd-Frank Act executive compensation provisions do not align with the Core Principles. The substance of the Section 954 clawback rule is best left to companies to implement in a manner that is tailored to their individual circumstances, which can be done after consideration of, among other factors, shareholder engagement. Pay ratio, pay for performance and the hedging policy disclosures (Sections 953(a), 953(b) and 955, respectively) create burdensome information obligations. None of these rules, as contemplated by the SEC's current proposed and/or final rulemakings, would provide new disclosure that would be material to any investor's investment decision. The SEC's three-part mission is to protect investors, to maintain fair, orderly, and efficient markets and to facilitate capital formation, not micromanage corporate governance or address purported social policy goals. SIFMA may comment further in subsequent submissions.

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[22] If the Agencies were to conclude that more formal action is necessary or desirable, the Agencies could take the additional step of adopting the 2010 Interagency Guidance as final regulations, with the regulations applying only to entities regulated by the Federal Reserve, the OCC and the FDIC and at the same time formally state that there is no need to expand the application of the 2010 Interagency Guidance to other financial institutions.

Chapter 8

KEY TOPICS IN BANKING REGULATION

Relevant Agency

- FRB

Chapter 8 – Key Topics in Banking Regulation

A. Control under the BHC Act

1. Original Problem to be Remedied

The BHC Act and its definition of control constrains the types of investors that can gain a controlling position in a U.S. bank or bank holding company, as well as the types of investments and relationships that a company that controls a bank may have in or with other companies. The original purposes behind the BHC Act and this policy were to prevent an undue concentration of resources, largely by enforcing the then-existing geographic and activities restrictions, as well as to maintain a strict separation between banking and commerce. Many of these considerations are no longer applicable and have been done away with by subsequent legislation.[1]

As originally enacted in 1956, the BHC Act contained only straightforward and objective tests to determine control: the company directly or indirectly owns, controls, or holds with the power to vote 25% or more of any class of voting securities of a bank, or the company controls in any manner the election of a majority of the directors or trustees of the bank.[2] The third and last test for control under the BHC Act, the "controlling influence test," was added by Congress in the 1970 amendments to the BHC Act, and, as interpreted by Federal Reserve policy and staff, has injected a great deal of uncertainty and subjectivity into the concept of control. The controlling influence test provides that a company has control of a bank or other company if the Federal Reserve determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.[3]

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[1] For instance, the separation of banking and commerce was modified by the Gramm-Leach-Bliley Act of 1999 and merchant banking investments for those institutions that meet certain requirements.

[2] 12 U.S.C. § 1841(a)(2)(A) and (B).

[3] 12 U.S.C. § 1841(a)(2)(C).

2. Need for Rebalancing

Since the controlling influence test was added to the BHC Act in 1970, the Federal Reserve has by regulation and practice altered and expanded this statutory standard. This expansion has been achieved through introducing additional subjectivity and extending the controlling influence test to apply to a large number of scenarios where no actual or operational control exists or is even possible as a business matter. Today, a complex web of Federal Reserve policy statements and unwritten nonpublic and changing views expressed by staff of the Federal Reserve governs a vast array of relationships around the globe. Additionally, because as a practical matter neither private equity investors nor highly regulated financial institutions can take the risk of investing, only to be told later that the Federal Reserve has a different view and then find themselves subject to a wide array of regulations with which they cannot comply, there is effectively no due process and the statutory requirement for notice and a hearing has become honored in the breach. The unfortunate consequence of this process, however, has been that decisions about whether a controlling influence may be present under the BHC Act are made non-publicly and in an arena of shifting guidance. Therefore, the BHC Act's controlling influence test has led and will continue to lead to significant hesitation on the part of potential investors in the banking sector and has acted as a brake on investments by the banking sector in other related areas.

For instance, under the Federal Reserve's controlling influence test, a company that controls 5% of the voting shares of another company and has a single director that serves on certain committees of that company may be found to have a controlling influence over the company, regardless of whether a single other shareholder controls the remaining directors or shares of the company and thus clearly has operational and strategic control. Likewise, a company that holds 10% of a class of voting shares of and has a single representative on the board of directors of another company, even if another shareholder has a significantly larger proportion of shares of board representation, often cannot be sure that it does not control the other company under the BHC Act unless it consults with Federal Reserve staff.

Further complicating the matter, because of the many interagency rulemakings required under the Dodd-Frank Act, the BHC Act's control standard and the nebulous controlling influence test have been applied in the context of joint rulemakings with other U.S. regulatory agencies that do not otherwise use the BHC Act control standard (e.g., the Volcker Rule and incentive compensation rules).

The controlling influence test, as applied by the Federal Reserve and its staff, and therefore the BHC Act definition of control, places financial companies in the position of having significant regulatory responsibility and risks, and legal liability, without having the practical ability to manage and mitigate those risks and liabilities. There is no reason why many of the minority investments by U.S. and non-U.S. banking organizations around the globe should be treated as subsidiaries or affiliates because of a "controlling influence." The effect of the Federal Reserve's controlling influence standard, especially because it extends beyond the scope of Congressional intent and is applied through nonpublic guidance, is inappropriately chilling. This effect is especially so with respect to the investments by banking organizations in venture capital and fintech companies, including U.S. companies which need access to this vital source of capital to ensure competitiveness in what has rapidly become a global and competitive marketplace.

3. Recommendations

- Unless the context specifically requires otherwise, for the purpose of interagency rulemakings and of rules not required to be implemented under the BHC Act, whether or not one company is viewed to be a subsidiary or affiliate of another company should be determined based on whether the first company is consolidated with the other for financial reporting purposes under GAAP or financial accounting standards, subject to limited exceptions such as for merchant banking portfolio companies.
    - This accounting-based approach is sensible because entities that are financially consolidated and subject to operational control are generally fully integrated into the parent's enterprise-wide governance, policies, procedures, control framework, business strategies, information technology systems and management information systems, thereby making compliance with any regulation simpler and less burdensome for all involved.
    - A financial consolidation standard better tracks where financial risks actually lie. A rule intended to mitigate financial risks shared by a group of related entities should recognize that entities that are consolidated with each other will experience related losses in the

most direct and correlated way. Losses experienced by unconsolidated entities flow through a banking organization's financial statements and capital accounts only to the extent of the banking organization's proportionate exposure reflected through equity accounting adjustments.

- The usefulness of this approach has been recognized by the Federal Reserve and other Federal financial regulatory agencies. For instance, financial consolidation was used to determine affiliate or subsidiary status in the swaps margin rules and Federal banking agencies' regulatory capital rules.
- Adopting this approach will have the salutary effect of adding certainty not only for BHCs but also those companies in which they invest or provide valuable financing and working capital.

- If the GAAP financial consolidation standard is not adopted for the purpose of defining control or "subsidiary" and "affiliate," at a minimum control should exclude from these definitions those entities over which a company does not exercise operational control and therefore does not have the practical ability to mandate compliance with a regulation or standard.

The Federal Reserve and its staff should update its "controlling influence" guidance to apply only to situations of actual control rather than hypothetical control and, at a minimum, all such guidance should be transparent, public and subject to notice and comment.

B. Single-Counterparty Credit Limits

1. Original Problem to be Remedied

The U.S. regulatory approach to credit exposure limits prior to the financial crisis was limited, addressed only some of the interconnectedness among large financial institutions and did not apply at the consolidated holding company level. One of the lessons of the financial crisis was that the consequences of failure of a large financial institution could be amplified by its interconnectedness with other large financial institutions, and potentially by its interconnectedness with non-financial firms. Section 165(e) of the Dodd-Frank Act authorized the Federal Reserve to establish single-counterparty credit limits, or SCCL, for banking organizations with total consolidated assets of $50 billion or more.

The Federal Reserve first proposed rules implementing section 165(e) in December 2011 for domestic banking organizations[4] and in December 2012 for foreign banking organizations,[5] and then re-proposed the rule for both types of banking organizations in March 2016 in order to take into account the large number of comment letters received on the original proposals and other domestic and international regulatory developments.[6]

2. Need for Rebalancing

The reproposal is in many ways an improvement from the original proposed rules, most notably with respect to more risk-sensitive methodologies for calculating derivatives exposures. Nonetheless, the reproposal contains significant flaws and weaknesses that would make the SCCL framework needlessly difficult to operationalize and inaccurate in application.

The reproposal is operationally complex and in some significant respects unworkable. The SCCL framework applies exposure limits between banking organizations and their counterparties, but, because it applies the BHC Act definition of control—which includes the facts and circumstances controlling influence test—to determine the entities that are consolidated for the purposes of determining these limits, it would impute to banking organizations and their counterparties a wide range of entities that pose no meaningful risk of loss to the banking organization.[7] In instances where a banking organization has only a minority interest in another entity and accounts for its investment using the equity method, losses that the entity incurs as a result of counterparty defaults do not flow through on a dollar-for-dollar basis to the financial statements and capital accounts of the banking organization, but instead flow through only to the extent of the banking organization's proportionate exposure reflected through equity accounting adjustments. The reproposal's consolidation approach also contains an operationally complex look-through requirement for

[4] Federal Reserve, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; Proposed Rule*, 77 Fed. Reg. 594 (Jan. 5, 2012) (link).

[5] Federal Reserve, *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies*, 77 Fed. Reg. 76628 (Dec. 28, 2012) (link).

[6] Federal Reserve, *Single-Counterparty Credit Limits for Large Banking Organizations; Proposed Rule*, 81 Fed. Reg. 14328 (Mar. 16, 2016) (link).

[7] See the discussion, in Section A of this Chapter, where SIFMA suggests simplifying the complex BHC Act definition of control.

securitization vehicles, investment funds and other special-purpose vehicles that does not take into account the nature or diversification of their underlying exposures. This consolidation approach artificially exaggerates the banking organization's actual exposure to the counterparty and compels a banking organization to account for exposures associated with the activities of minority-owned entities over which it has no control, potentially leaving the banking organization unable to manage exposure against the applicable regulatory limit.

Furthermore, because of the breadth of the concept of controlling influence in the BHC Act control definition, exposures to entities in which the banking organization lacks any economic interest at all could be required to be aggregated with the banking organization's exposures. The application of the BHC Act control definition to this context could counterintuitively result in some entities being treated as part of both a banking organization and one of that organization's counterparties.

The reproposal becomes even more complex and unworkable in defining counterparty, in that it applies the BHC Act definition of control, but also requires banking organizations to analyze, where exposures to a counterparty exceed 5% of the eligible capital base, whether that counterparty is economically interdependent with any other counterparties of the banking organization, as determined by an open-ended laundry list of factors. Evaluation of these factors would require an impracticable amount of due diligence and would almost certainly require information that is not public or otherwise readily available, particularly in the case of counterparties that are not publicly reporting companies and are not in regulated industries. The lack of publicly available information and expense associated with obtaining the necessary level and detail of information will in many cases outweigh the potential profitability of the relationship.

The reproposal would also impose a far more stringent exposure limit on exposures between G-SIBs, but the Federal Reserve did not consider other regulatory initiatives addressing the systemic significance of large banking organizations as discussed in Chapters 2, 3 and 5, making them less likely to fail, in justifying this calibration. Since the financial crisis, the Federal Reserve has enacted other prudential requirements that have the same objective of making financial institutions more resilient to the failure of other large financial institutions, including the G-SIB surcharge, resolution and recovery planning and the risk-based capital rules' provisions requiring banking institutions to deduct from their own capital their holdings of capital securities of non-consolidated financial institutions. Elements of the G-SIB surcharge in particular are targeted towards reducing interconnectedness among large financial institutions, and together with these other reforms reduce substantially the probability and potential systemic impact of the failure of a systemically important financial institution.

In addition, the reproposal's measurement methodology for calculating securities financing transaction exposures is based on the existing and highly risk-insensitive collateral haircut approach. This approach, which has widely recognized flaws, will result in a significant overstatement of the risk of securities financing transactions and could cause banking organizations to pull back from this activity as a result. In light of the critical role of securities lending in the broader U.S. securities markets, flaws in the securities financing transaction measurement methodology could have severe market consequences.

In reality, exposures to most counterparties most of the time will not approach a banking organization's exposure limit under the SCCL framework. Banking organizations should be devoting their resources to identifying and monitoring those that do, rather than continuously tracking down remote connections among counterparties to which the banking organization has *de minimis* exposures, and about which the banking organization has limited information to analyze. An over-inclusive definition of counterparty, overly stringent exposure limits in certain cases and risk-insensitive exposure measurement methodologies are likely to have the consequence of restricting the amount of credit banking organizations may decide to make available to certain counterparties. For these reasons, the SCCL reproposal is contrary to Core Principles (c) (foster economic growth and vibrant financial markets) and (f) (make regulation efficient, effective, and appropriately tailored).

3. Proposed Recommendations

- The reproposal should be withdrawn.
- If the reproposal is not withdrawn, the reproposal should not be finalized and in any reproposal:
  - The Federal Reserve should use much simpler consolidation standards for both banking organizations and counterparties. Using

instead the GAAP financial reporting-based regulatory consolidation group would bring within the scope of the SCCL framework those exposures that truly put a covered company's capital at risk, as has long been recognized under the U.S. regulatory capital standards. All true economic exposures would be more accurately captured under this approach. This recommendation aligns with the recommendations in the discussion of control under the BHC Act in Section A of this Chapter.

- The Federal Reserve should modify the look-through requirement for securitization vehicles, investment funds and other special-purpose vehicles in a risk-sensitive manner to ensure that the requirement can be operationalized.

- The Federal Reserve should consider the reduced probability of default by a G-SIB as result of other regulatory initiatives.

- The Federal Reserve should allow banking organizations to calculate securities financing transaction exposures using any methodology permitted for risk-based capital purposes, consistent with the reproposal's approach for measuring derivatives exposures.

- The Federal Reserve should address other flaws in the reproposal, as set forth in the comment letter prepared by SIFMA and other trade organizations on the reproposal, dated June 3, 2017.[8]

C. Physical Commodities Activities

1. Original Problem to be Remedied

The Federal Reserve released a proposed rule on September 23, 2016 that would significantly curtail the physical commodities activities of FHCs, intending to address speculative concern about the tail risk of legal liability associated with certain physical commodities activities by FHCs. The Federal Reserve did not, however, offer any evidence to support this

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[8] The Clearing House, American Bankers Association, The Financial Services Roundtable, SIFMA, International Swaps and Derivatives Association, *Comments in Response to the Notice of Proposed Rulemaking – Single Counterparty Credit Limits for Large Banking Organizations* (June 3, 2016) (link).

speculative concern or explain why existing controls and safety and soundness supervision were inadequate to address these risks.

FHCs engage in physical commodities activities through a number of authorities under the BHC Act. Through these activities, FHCs provide customers with a better and more diverse array of risk management and financing options, increase competition and liquidity in commodities markets, increase the efficiency of commodities supply chains, facilitate price convergence between physical and derivatives markets and make commodities markets more publicly transparent—helping small and mid-sized businesses expand their scale and geographic reach.

> "Banks have emerged as the credit worthy counterparty to tailor corporate hedging transactions. This customer-facing role is a natural extension to traditional banking services. This client-facing business model creates a primary impetus for being in the physical commodity markets—on behalf of or in support of client needs. There are many important reasons behind the need for these bank services in the commodities markets. For instance, exchange traded solutions frequently are not available, not sufficiently liquid, not available in sufficient size or not appropriately matching the desired period of time, i.e., they create too much basis risk."[9]
>
> *– IHS Global, Inc.*

The Federal Reserve's proposed rule follows the Federal Reserve's 2014 advance notice of proposed rulemaking on the physical commodities activities of FHCs.[10] It would impose punitive capital requirements and other restrictions on certain physical commodities activities of FHCs conducted under the BHC Act, including holdings by FHCs of specified physical commodities; certain merchant banking investments in portfolio companies engaged in activities relating to specified physical commodities, including trading, storage, transportation and refining and assets held pursuant to section 4(o) of the BHC Act other than physical commodities.

Owning assets in each of these categories would be subject to a combination of additional and significantly increased capital charges, with risk weights under the U.S. Basel III capital rules ranging from 300% to 1,250%; the latter would require FHCs to hold more capital against an asset than the asset's value.

These new capital charges are designed to address what the Federal Reserve has characterized as the tail, i.e., speculative or remote, risk of legal liability associated with engaging in certain activities with respect to certain commodities, citing the risk that FHCs might be subject to legal liability in an amount greater than the value of their investment as a result of an environmental catastrophe. The Federal Reserve also cited the risk that an

[9] IHS GLOBAL, INC., THE ROLE OF BANKS IN PHYSICAL COMMODITIES 10 (2013).

[10] Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 3,329 (Jan. 21, 2014) (link); Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 12,414 (Mar. 5, 2014) (extending the comment period to Apr. 16, 2014) (link).

FHC and its affiliates might temporarily suffer limited access to funding markets in the event of an environmental catastrophe linked to the FHC's physical commodities activities.

In an attempt to justify the proposed punitive capital charges for certain merchant banking investments in portfolio companies engaged in activities relating to specified physical commodities, the Federal Reserve cited the risk associated with merchant banking investments generally, potential reputational risks, and the possibility that the corporate veil might be pierced and that the FHC might be held liable for environmental damage caused by the portfolio company.

2. Need for Rebalancing

The Federal Reserve did not provide a single example of an FHC actually suffering either legal liability or loss of funding following reputational harm as a result of its physical commodities activities, whether conducted directly by the FHC or through a merchant banking portfolio company. Consequently, the Federal Reserve is left with a speculative concern about hypothetical risks that have never materialized.

The extensive empirical data about commodities-related losses actually incurred by BHCs available at the time of the release of the proposed rule show that the Federal Reserve's concerns are unfounded. There is no empirical or legal basis to suggest that there is a significant joint risk of both an underlying environmental hazard and any such event resulting in legal liability or reputational harm.[11]

The Federal Reserve overstated the risk of legal liability in cases where an FHC owns physical commodities, such as when an FHC engages in physical commodities trading activities. The range of physical commodities covered by the proposal is so broad as to be unworkable, as it included a wide range of allegedly environmentally sensitive substances, including iron, copper and nickel, found in normal household items, food, drinking water, vitamins and other items meant to be used or ingested by the public.

[11] For an extended discussion of bases for potential legal liability, see Joint Memorandum of Law prepared by Covington & Burling LLP, Davis Polk & Wardwell LLP, Sullivan & Cromwell LLP and Vinson & Elkins LLP to comment letter on the proposed physical commodities rule from SIFMA and the Institute of International Bankers (Feb. 17, 2017) (link).

The proposed capital requirements for trading in specified physical commodities and investing in infrastructure assets would be in addition to existing risk-based capital requirements for these activities. For both of these activities, banking organizations using the advanced approaches for capital requirements are already subject to risk-based capital requirements for credit risk, market risk and operational risk. Credit risk capital requirements are intended to cover, among other risks, the bankruptcy risk of a company in which an FHC has made an equity investment and the consequent risk of loss of the entire value of the investment. Operational risk capital requirements are intended to reflect, among other risks, the risks of legal liability related to the banking organization's activities. Given that legal liability risk is also one of the principal stated justifications for the proposed capital requirements on these activities, these requirements would be duplicative of the existing capital requirements for operational risk.

The proposed requirements would lead to illogical results, requiring for some activities that FHCs maintain more capital than the amount of their investment when there is no reasonable possibility that they could lose more than the value of their investment. The Federal Reserve also did not provide any basis for calibration of the proposed requirements. For these reasons, the proposed rule on physical commodities is contrary to Core Principle (f) (make regulation efficient, effective, and appropriately tailored).

The Federal Reserve did not consider any of the benefits of physical commodities activities by FHCs in calibrating these proposed capital requirements. Similar to the 40 comment letters to the Federal Reserve's 2014 advanced notice of proposed rulemaking,[12] the 2016 proposal also drew comments from a diverse group of parties, including end-users of commodities and commodity-based derivatives. The end-users continued to highlight that FHCs are highly stable market-makers and able to provide customers with a better and more diverse array of risk management and financing options, increase competition in commodities markets, increase the efficiency of commodities supply chains, increase liquidity in commodities markets, facilitate price convergence between physical and derivatives markets, make commodities markets more publicly transparent and help small and mid-sized businesses expand their scale and geographic

[12] For a summary of comment letters on the 2014 Advanced Notice of Proposed Rulemaking, see DAVIS POLK & WARDWELL LLP, THE FED'S PHYSICAL COMMODITIES ANPR (Apr. 28, 2014) (link).

"In facilitating the exchange of physical commodities, FHCs help to stabilize commercial growth by providing a mechanism in which businesses can manage their short- and long-term inventory needs…The [2016 proposal], however, would drastically reduce an FHC's ability to provide such services by increasing funding costs… As FHC affiliates are frequently the most knowledgeable, most willing and most equipped participants to address [its] market-necessary customized trades, [it] will likely experience a drastic reduction in the volume and variety of commodities-based products."[14]

– Alon USA Energy, Inc.

"As a result of [pullback of U.S. banks in the commodities markets since 2008], PES has already had to restructure [their] use of tailored derivative arrangement formerly provided by these entities at significant cost and disruption to [their] business operations."[13]

– Philadelphia Energy Solutions LLC

"FHCs are among the primary participants in this marketplace as gas suppliers. As such they provide an essential service to the municipal gas industry, one that [they] believe could not and would not be replicated or replaced by other market participants, at least not under market conditions that have prevailed over at least the past ten years." They went on to highlight a long-term gas prepayment transaction that enables 150 cities and towns, spread across several southern states, to have stable energy prices for the next 30 years.[15]

– Black Belt Energy Gas District

reach. The commenters further expressed concern that non-bank financial institutions lack the institutional knowledge, capital, creditworthiness, transparency, and regulatory oversight necessary to serve as market makers and price commodities-related products as efficiently. For these reasons, the proposed rule on physical commodities is contrary to Core Principle (c) (foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis).

Excerpts from just a few of the letters submitted by end-users in response to the 2016 proposal are shown in the sidebars.

3. Proposed Recommendations

- The proposed rule on the physical commodities activities of FHCs should be withdrawn.
- If the proposed rule is not withdrawn, the proposed rule should not be finalized and any reproposed rule should be subject to well-established standards of rulemaking under the Administrative Procedure Act:
    - The Federal Reserve should be required to support with empirical data its belief that FHCs could incur losses from environmental liability related to these activities.
    - The Federal Reserve should be required to consider benefits of physical commodities activities and to undertake a rigorous cost-benefit analysis comparing the costs of imposing higher capital requirements against the risks posed by these activities and the benefits conferred, considering the consequences that would result from FHCs significantly reducing or even terminating their physical commodities activities.
    - If the Federal Reserve finalizes the proposed rule without complying with these requirements, the Congressional Review Act should be used to override the final rule.

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[13] Comment letter on proposed physical commodities rule from Philadelphia Energy Solutions (Dec. 20, 2016) (link).

[14] Comment letter on proposed physical commodities rule from Alon USA Energy (Feb. 20, 2017) (link).

[15] Comment letter on proposed physical commodities rule from Black Belt Energy Gas District (Feb. 21, 2017).

- If the proposed rule is not withdrawn, the proposed rule should not be finalized and any reproposed rule should:
  - Contain a revised definition of covered physical commodity to avoid subjecting FHC's activities and investments that are related to drinking water, metals, consumer electronics, cleaning products, and other commodities, such as agricultural commodities to the proposed rule's punitive capital requirements; and
  - Address other flaws in the proposal, including for example the unjustified further restrictions on physical commodities trading activities under the complementary powers orders and section 4(c)(8) of the BHC Act, as detailed in SIFMA's comment letter on the proposed rule, dated February 17, 2017.[16]

[16] Comment letter on proposed physical commodities rule from SIFMA and Institute of International Bankers (Feb. 17, 2017) (link).

D. Merchant Banking

1. Original Problem to be Remedied

> "I am also glad that the conference report will permit financial institutions to engage in merchant banking activities. This will allow banks to invest in small companies for the purpose of appreciating and ultimately reselling the investment. The merchant banking provisions limit the day-to-day management of companies by financial institutions and the duration of the investment. I am hopeful that these new powers will allow banks to provide more capital for small businesses, which have been leading contributors to the economic growth of our country."[17]
>
> *– John Kerry, former U.S. Senator and Secretary of State*

FHCs make investments in nonbanking companies through merchant banking authority, contributing to employment and economic growth by providing capital to companies in the growth, expansion and mature stage and are an important source of funding in many industries. Between 1983 and 2009, 30% of all U.S. private equity investments were sponsored by the private equity arm of a large bank.[18] As of 2015, the carrying value of merchant banking investments held by FHCs globally was $26.78 billion.[19] In this vein, the conference report for the Gramm-Leach-Bliley Act, which was issued in connection with Congress' passage of that Act, recognized the "essential role that [merchant banking] activities play in modern finance."[20]

Merchant banking investments are particularly important to the renewable energy sector, which relies on FHCs for roughly 40% of that market's annual financing needs, according to a data study undertaken by The Clearing House. That data study also found that FHCs have over $30 billion in direct equity investments under merchant banking authority, providing alternative forms of financing to traditional bank loans and other capital markets instruments, which may be more expensive or unavailable to such companies, and have seeded over $200 billion in funds that make merchant banking investments with just over $7 billion in seed or co-investment capital, suggesting a multiplier effect where a limited amount of seed or co-investments can support a much larger amount of capital invested in the marketplace.[21]

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[17] John Kerry, Former Secretary, Dep't of State, *Discussion of Financial Services Modernization Act of 1999, Conference Report*, 145 Cong. Rec. S. 13883, 13904 (Nov. 4, 1999).

[18] Lily Fang, Victoria Ivanshina & Josh Lerner, *Combining Banking with Private Equity Investing*, 26 REV. OF FINANCIAL STUDIES 9, 2139 (2013).

[19] FED. RESERVE, FDIC & OCC, REPORT TO THE CONGRESS AND THE FINANCIAL STABILITY OVERSIGHT COUNCIL PURSUANT TO SECTION 620 OF THE DODD-FRANK ACT (2016).

[20] H.R. Conf. Rep. No. 106-434 to Accompany S. 900, Gramm-Leach-Bliley Act 154 (Nov. 2, 1999).

[21] Comment letter on Risk-based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-based Capital (….continued)

The preamble to the proposed rule on physical commodities raised the prospect of future action to increase capital charges for *all* merchant banking investments, in addition to just merchant banking investments relating to specified physical commodities, as well as adjusting the Federal Reserve's risk-based capital rules to no longer consider merchant banking investments as non-significant equity exposures.

2. Need for Rebalancing

The Federal Reserve overstates the risk of liability where an FHC's activity is limited to an investment in a subsidiary, such as a merchant banking portfolio company, because Section 4(k)(4)(H) of the BHC Act and the Federal Reserve's implementing regulations generally prohibit an FHC from routinely managing or operating any portfolio companies to address the issue of corporate separateness that could provide the basis for veil piercing. The Clearing House's data study, looking at merchant banking investments held in 2015, found that out of 1,142 merchant banking investments held at year-end 2015 in its data set, none had been subject to routine management or operation in 2015. The possibility that an FHC would be held liable for the activities of a portfolio company in which it has a merchant banking investment pursuant to a veil piercing theory is therefore extremely remote. Of the 372 investments sold with losses in The Clearing House's data set, zero investments were sold with losses in excess of capital invested, which was their proxy for veil-piercing.

With respect to merchant banking investments in particular, The Clearing House's data study found that U.S. Basel III risk-based capital requirements applicable to merchant banking investments are already approximately 35% higher than the 95th percentile of realized losses on merchant banking investments over the past 15 years, a period which includes the most severe economic downturn in the post-war period. Banks subject to the CCAR global market shock are effectively subject to an average capital requirement equal to approximately 45% of the carrying value of private equity merchant banking investments.

For these reasons, any future action by the Federal Reserve to increase capital charges for all merchant banking investments would be contrary to

(continued….)

Requirements for Merchant Banking Investments from The Clearing House (Mar. 10, 2017) (link).

Core Principles (c) (foster economic growth and vibrant financial markets through more rigorous impact analysis) and (f) (make regulation efficient, effective, and appropriately tailored).

3. Proposed Recommendations

- The Federal Reserve should not take any future action to increase capital charges for all merchant banking investments or adjust its risk-based capital rules to no longer consider merchant banking investments as non-significant equity exposures.

Chapter 9

SECURITIZATION

Relevant Agencies

- CFPB
- FDIC
- FHFA
- FRB
- HUD
- OCC
- SEC

Total household indebtedness was $12.58 trillion as of December 30, 2016, an amount equal to 70% of GDP.[3]

Chapter 9 – Securitization

Two telling statistics illustrate the significance of securitization. The first statistic is that approximately 60% of all consumer credit in the U.S. in 2016 was financed in the securitization markets.[1] Given how significant securitization is to the financing of consumer credit, the total outstanding amount of which is $12.58 trillion and equal to approximately 70% of the GDP,[2] it is clear that well-tailored securitization rules are a key to restoring the growth and efficiency of the real economy. Tailoring securitization rules more closely to their purposes by paring them of overly conservative and redundant capital and liquidity requirements, and rationalizing disclosure, credit risk retention, derivative, proprietary trading, mortgage origination and other rules would have a material beneficial effect on the provision of credit to consumers and consequently the real economy without compromising the safety and soundness of the financial system.

The second statistic is that it has been estimated that had the capital requirements for securitization been rationalized, the complexity of disclosure been limited to what was reasonable and other related securitization and lending regulations been similarly tailored, approximately $1 trillion of additional residential mortgage loans would have been made over the last five years, resulting in the increase of GDP by 0.5% in each of those years.[4]

Poorly tailored regulation of securitization is not just a concern of large banking organizations; it is a serious concern for small and mid-size businesses, community banks, and consumers—indeed, the entire economy and all who participate in it. The U.S. financial markets, notwithstanding their undeniable strength, would be even more competitive on a global level with an efficiently functioning securitization market. Much of U.S.

[1] FED. RESERVE BANK OF N.Y., QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT (Feb. 2017) (link); SIFMA, US MORTGAGE-RELATED ISSUANCE AND OUTSTANDING (Apr. 6, 2017) (link); SIFMA, US ABS ISSUANCE AND OUTSTANDING (Apr. 6, 2017) (link).

[2] THE WORLD BANK, GDP (CURRENT US$) (Mar. 23, 2017) (link).

[3] FED. RESERVE BANK OF N.Y., QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT (Feb. 2017) (link); THE WORLD BANK, GDP (CURRENT US$) (Mar. 23, 2017) (link).

[4] Letter from Jamie Dimon, Chair of the Board and CEO, JP Morgan Chase, to shareholders 29 (Apr. 4, 2017) (link).

> "[S]ecuritization markets are an important source of credit to U.S. households and businesses and state and local governments. When properly structured, securitization provides economic benefits that lower the cost of credit to households and business."[5]
>
> *– John Walsh, Acting Comptroller of the Currency, OCC*

consumer, and business, credit is financed through securitization and so much more could be financed on a more competitive basis. While the benefits of securitization are well known, it is worth repeating that securitization in particular can provide to U.S. households and businesses a lower cost of funding, diversification of sources of funding, greater capital efficiency and enhanced liquidity.

A. Original Problems to be Remedied

Weaknesses in the securitization process as practiced before the financial crisis are widely understood to have been one of the causes of the crisis. As a result, a host of new and at best loosely coordinated regulations and laws have been adopted to attempt to strengthen those weaknesses.

Capital and Liquidity Rules for Securitizations

One of these perceived weaknesses was that capital held for securitization positions was inadequate, particularly in times of financial system stress, and that securitization positions might not be as liquid as had previously been thought. Accordingly, the U.S. risk-based capital requirements and Basel Committee global standards have been amended to increase capital for, among other things, securitization positions.[6] The LCR was created and implemented with no credit given in calculating the HQLA numerator for asset-backed securities or non-agency mortgage-backed securities and allocating Fannie Mae and Freddie Mac guaranteed residential mortgage-backed securities to a lower level of HQLAs that includes a haircut and caps.[7] Finally, in calculating the adequacy of capital for purposes of

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[5] *Enhanced Oversight After the Financial Crisis: The Wall Street Reform Act at One Year: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong. (statement of John Walsh, Acting Comptroller of the Currency) (July 21, 2011) (link); *Wall Street Reform: Oversight of Financial Stability and Consumer and Investor Protections: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 113th Cong. (statement of Thomas Curry, Comptroller of the Currency) (Feb. 14, 2013) (link).

[6] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,017 (Oct. 11, 2013) (link).

[7] Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61,439 (Oct. 10, 2014) (link).

CCAR, the shocks calculated for securitization were made extraordinarily high.[8]

Regulation AB II

Regulators and legislators also believed that disclosure could be improved and made more robust. Accordingly, the SEC adopted Reg AB II which was intended to address the perceived failure to provide adequate disclosure to permit investors to make informed decisions by requiring prospectuses for public offerings of asset-backed securities, among other reforms, to include specified additional asset-level data that would permit investors to understand the risks of the related asset-backed securities and to value asset-backed securities accordingly.[9]

Credit Risk Retention

The credit risk retention rules are another cornerstone of the post-crisis regulatory response. Following the financial crisis, there was a concern that many securitizers' business plans were based on an originate to distribute model that left many securitizers with interests that were not aligned with those of their borrowers or investors. As a result, Section 941 of the Dodd-Frank Act provided for, and several regulatory agencies implemented, rules requiring sponsors, subject to some exceptions, to retain an economic interest in the credit risk of the assets that they securitize to promote better alignment of borrower-securitizer-investor incentives.[10] These rules became effective in 2015 and 2016.

Derivatives: Margin Requirements for Securitizations

Many legislators and policymakers viewed the inadequate regulation of OTC derivatives as having contributed to the crisis. As a result, the Dodd-Frank Act included substantial reform of OTC derivatives, as described in Chapter 6. Of particular concern here, the rules require securitization

[8] Capital Plans, 76 Fed. Reg. 74,631 (Dec. 1, 2011) (link).

[9] Asset-Backed Securities Disclosure and Registration, 79 Fed. Reg. 57,183 (Sept. 24, 2014) (link).

[10] Credit Risk Retention, 79 Fed. Reg. 77,601 (Dec. 24, 2014) (link).

transactions to post margin for derivatives that may be embedded in the securitization structure.

Qualified Mortgage Standards

Members of the government also viewed the inadequate underwriting of residential mortgages, especially subprime mortgages, as contributing to the financial crisis. Accordingly the CFPB adopted the QM Rule to require lenders to conclude that a borrower has an ability to repay a loan before extending a loan, and to define how lenders may determine that the borrower has an ability to repay a mortgage loan.[11]

Volcker Rule: Application to Securitization

Although the original policy impulses behind the Volcker Rule had nothing to do with securitization, as implemented by the regulators, the overbroad definition of covered funds has swept up securitization in its wake.

TRID

Pursuant to a mandate under the Dodd-Frank Act, the CFPB promulgated a final rule integrating certain residential mortgage loan disclosures required under the TILA and the RESPA. The final rule is known as the TRID. The objective of TRID was to harmonize overlapping and inconsistent language in the old disclosures in order to reduce consumer confusion. To that end, TRID requires residential mortgage creditors to provide two new disclosure forms to consumers—a Loan Estimate and a Closing Disclosure. The forms use clear language and design to make it easier for consumers to locate key information, such as interest rate, monthly payments, and closing costs. The forms also provide information to help consumers decide whether they can afford the loan and to compare the cost of different loan offers.

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[11] Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6,407 (Jan. 30, 2013) (link).

B. Need for Rebalancing

Capital and Liquidity Rules Are Excessively Conservative and Insufficiently Tailored to the Actual Risks of Securitizations (Core Principles (f))

SIFMA supports many of the post-crisis regulatory reform efforts in the areas of capital and liquidity, which have helped restore market confidence in the U.S. financial system and generally made the U.S. financial system stronger and more resistant to financial stress. SIFMA believes that now is the appropriate time to evaluate whether and to what extent there are aspects of the U.S. capital and liquidity requirements that impose costs on the U.S. financial markets that outweigh their benefits, as discussed in Chapters 2 and 3.

The capital and liquidity rules that have been adopted or proposed for securitization positions and their eligibility for HQLA status are a strong example of how regulations can lead to negative effects on lending, jobs, economic growth and competitiveness. Capital requirements are increasingly risk-insensitive while both capital and liquidity requirements are excessively conservative and do not adequately consider the effects on financial market activity.[12] There are a number of flaws in the capital and liquidity rules applicable to securitization, the overall effect of which has been to diminish the participation by banking institutions in the securitization process both as investors and as originators, and thereby to decrease the availability of funding to the real economy.

Large, medium and small businesses, providers of credit that depend on securitization for some portion of their funding needs and consumers who are or could be their customers each feel the effect of this unwarranted increase in the relative capital intensity of securitization, to the detriment of

[12] Even taking solely investment grade and above securitization positions into consideration, one of our members has calculated that in their experience on average the increase in required capital has been approximately 300% to almost 500%; i.e., even for investment grade securitization positions, it can be generalized that required capital has increased in whole multiples of previously required capital. The effect of this securitization specific increase is also magnified by the fact that the required amount of capital for the numerator itself in the risk based capital ratio formula has been materially increased for U.S. banks above all others and especially G-SIBs who accomplish much of the securitization financing for banks in the market place, as discussed in Chapter 2.

our economy as a whole. Other forms of financing are not likely to replace securitization which means that the needed funding will not be available at the same price. Instead, many financings may not get done if securitization is less widely available and even if they are done, the cost will be higher. The end result is that less credit will be provided—and what credit is provided will often be more expensive.[13] If capital requirements were rebalanced, and securitization's liquidity characteristics more sensibly recognized, growth and employment would follow without any material diminution in safety or liquidity.

With sensible reform that continues to protect taxpayers from risks, the capacity to provide substantial additional credit to the U.S. financial markets can be freed up, spurring growth, increasing employment and maximizing the competitiveness of our capital markets.

Regulation AB II Is Overly Prescriptive and Inflexible (Core Principle (c))

Regulation AB II is overly burdensome and has effectively shut down registered markets for non-agency residential mortgage-backed securities and has significantly curtailed registered issuance for smaller or more infrequent asset-backed securities issuers. While private offerings—unregistered, often relying upon Rule 144A—remain viable, they face the risk of proposed similar regulation and, by definition, are constrained sources of capital and funding since the investor base is far smaller than that for registered transactions. This regulation has effectively constrained real economy activity that public offerings of securitization transactions could more efficiently fund. These prescriptive, inflexible, and excessive requirements substantially increase legal risk to securitizers and put securitization, and their related markets for financial products and services, at a competitive disadvantage compared to other forms of financing. It is time to evaluate whether the costs to financial markets of Regulation AB II outweigh the perceived benefits of the complex disclosure it requires.

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[13] Faten Sabry & Chudozie Okongwu, *Study of the Impact of Securitization on Consumers, Investors, Financial Institutions, and the Capital Markets* (American Securitization Forum Report, June 17, 2009) (link).

Credit Risk Retention Rules Are Not Tailored To Specific Asset Classes (Core Principle (f))

The credit risk retention rules are very lengthy, detailed, and complex yet fail to adequately reflect important characteristics of the different kinds of securitization transactions that finance distinct asset classes, such as mortgage loans, auto loans, and commercial loans. In some cases the rules require an excessive amount of risk retention by failing to make any adjustment for the related funding and non-credit risks, for example, market and interest rate risk, or to give appropriate credit for other forms of risk retention. Empirical evidence was submitted to the agencies that demonstrated that 5% of fair value was excessive and far more than the statutory required 5% of credit risk.[14] The rules are overly prescriptive regarding the manner in which the required retention must be held and for many asset classes require that the retention be held well beyond the period in which weak underwriting, or other similar moral hazard, would be expected to become evident.

Additionally, the corresponding rules in the EU are materially different from the U.S. rule in several respects, although the EU is apparently developing a direct option that may somewhat resemble the U.S. rule, and, as a result, the U.S. and EU rules need to be harmonized and rationalized for efficiency and to ensure a level playing field for U.S. securitizers.

Derivatives Rules For Non-Cleared Swaps Go Beyond What Is Necessary to Mitigate Risk to Securitization Counterparties, Unduly Impeding U.S. Job Creation and Economic Growth (Core Principles (c))

In implementing the reforms of the OTC derivatives, the regulators have imposed a complex, costly and over-engineered set of rules, as discussed in Chapter 6. One important corner of markets they have disrupted is securitization because of the requirements for initial and variation margin for uncleared swaps with securitization special purpose entities. Many securitization transactions employ swaps to match or hedge the cash flows

[14] Comment letter on credit risk retention proposed rule from the Loan Syndications and Trading Associations (Apr. 1, 2013) (link)

that arise from the assets that collateralize the transaction to those which are required to be paid to investors in the liabilities issued by the transaction.

These regulations fail to reflect the fact that special purpose entities are different from typical counterparties on flow-traded swaps. Special purpose entities are not operating companies, and they contain special structural features designed to mitigate counterparty risk, such as the fact that payments by the securitization special purpose entity to a swap counterparty are usually made at a senior position in the related transaction waterfall and that derivatives counterparties have secured creditor status, in the event of a default.

As a practical matter, special purpose entities will find it difficult if not impossible to comply with the margin and clearing requirements as implemented and will either have to forego derivatives and their risk mitigating benefits or find a way to comply which will not be efficient for the transaction. Either way, the rules will have a harmful effect on the cost and availability of securitization as a financing tool hindering the vibrancy of the financial markets.

Qualified Mortgage Standards Are Unduly Complex While Lacking Clarity, Leading to Legal Uncertainty (Core Principle (g))

While the CFPB published the lengthy and detailed QM rules and their Appendix Q in an effort to provide guidance to lenders on how to underwrite loans in compliance with the law, the practical impact has been that the requirements are complex, inflexible and fail to properly take into account differing circumstances of particular types of borrowers. At the same time, despite their complexity, the rules and their appendix lack important clarity on critical aspects of the lending process. For example, how a lender may rely on borrower bank statements or document the income of self-employed borrowers remains unclear years after the rules were enacted. Lenders, securitizers and investors have found it difficult to obtain written guidance on these and similar issues upon which they can be comfortable relying.

Volcker Rule: Application to Securitization Is A Consequence of Overly Broad Definition of Covered Funds (Core Principles (c) and (f))

The agencies responsible for implementing the Volcker Rule created an overly inclusive definition of covered fund, as described in Chapter 4, that subjects many securitization entities to the Volcker Rule's restrictions, even though they are clearly not private equity or hedge funds. The compliance burden for banking organizations that hold or trade securitization transactions is significant, with no or few corresponding benefits. This misapplied rule has had a deleterious impact on the securitization markets and has required some types of securitization transactions to be restructured to avoid its burdens.

TRID Compliance Requirements Unduly Increase Costs of Consumer Loans and Restrict Secondary Market Liquidity (Core Principle (c))

Lingering misperceptions and technical ambiguities in the regulations have resulted in significant market disruptions. Many market participants are reporting very high TRID fail rates on closed loans delivered for sale. Moody's recently reported that approximately 90% of one sample of loans did not fully comply with TRID requirements.[15] If these conditions persist, many lenders will experience liquidity issues as unsold or repurchased loans clog warehouse funding lines and balance sheets. Further, although some lenders may have multiple investor options, investors often have different standard for TRID compliance. As a result, originators are not always able to deliver loans to the investor with the best price, and hence the best rate for the consumer, and instead must deliver based on investors' TRID interpretations. For consumers, these dynamics will increase both the costs of origination and the interest rates they pay.

[15] MOODY'S INVESTORS SERVICE, U.S. MORTGAGE LENDERS FACE DIFFICULTIES COMPLYING WITH NEW RULES, A CREDIT NEGATIVE FOR RMBS (Dec. 10, 2015).

C. Proposed Recommendations

Capital and Liquidity Rules

- The CCAR rules for calculating capital to deal with defined shocks to the system for securitizations are excessive and should be revised for securitization positions.

- The global market shock scenario should be recalibrated to recognize that there has been much regulatory reform since the crisis and that bonds backed by different asset classes in securitization will be subject to varying degrees of shock themselves.

  - The global market shocks calculated for securitization assume that market conditions pre-crisis continue to exist today and do not take into consideration the legislative and regulatory reforms that have been implemented, including but not limited to: a leverage ratio, the LCR, rating agency reform, new disclosure requirements both in the Dodd-Frank Act and the now effective Reg AB II, new minimum underwriting standards, otherwise higher capital requirements, credit risk retention rules, all of which make it much more unlikely that shocks to the system will occur with the same force as in the financial crisis.

    - For example, the CCAR global market shocks assumption for AAA rated residential mortgage-backed securities, whether prime or subprime, is 31.5%.

  - Different types of collateral have different characteristics that affect their susceptibility to such shocks.

    - For example, *ceteris paribus*, assets with different loan-to-value ratios will respond to macro shocks with different degrees of resiliency.

- The recent Basel III revisions to securitization capital requirements,[16] that have not yet been applied to the risk-based capital requirements in the United States, should not be adopted, or, if they are adopted, their deficiencies should be addressed so that in either case the U.S. risk-

[16] BASEL COMM., REVISIONS TO THE SECURITIZATION FRAMEWORK (Dec. 2014).

based capital requirements for both the banking book and trading book have the following terms:

- The risk weight floor should be lowered to 15%, as it will have been in the EU, which is adequate to protect banks from unanticipated losses and will maintain parity between the U.S. and European capital markets.
- The "p" factor, an arbitrary supervisory add on to create extra capital to distribute among tranches held by third parties, should be maintained at 0.5 in the SSFA (rather than 1.0 as under the Basel III revisions).
    - There is no evidence that such extra capital needs to equal 100% (i.e., p=1) of otherwise required capital instead of the already very conservative extra 50% (i.e., p=0.5) of such capital. The greater the p factor, the less sensitive the formula will be to risk and the more arbitrary capital levels will be on an absolute basis and relative to other jurisdictions.
- The "Kg" factor used to calculate capital for securitization positions in the SSFA should be adjusted to be more risk sensitive.
    - The "Kg" factor is the same for all asset classes except for certain residential mortgage-backed securities that have a risk weight of 50%. The Kg factor should be adjusted to take account of credit quality at a more granular level since different types of financial assets will have different risk profiles. Because the SSFA already takes into account different credit enhancements (with higher enhancement levels resulting in lower risk weights) and lower quality asset classes require more enhancements, a fixed Kg has the counter-intuitive effect of increasing risk weights for higher quality asset classes. For example, subprime residential mortgages have a different credit quality than prime credit card receivables, yet they are treated the same.
- SSFA should be adjusted to take account of the added credit enhancement when a bank purchases a securitization position at a discount.

   - The effect on calculating risk based capital in the Advanced Approach should be made more risk sensitive by recalibrating the effect on required capital of the maturity of a tranche.
      - For example, maturity of a tranche should be calculated by reference to the weighted average life, which is realistic, rather than by reference to legal final maturity, which is unrealistic and excessively conservative, as legal final maturity is calculated to ensure that every non-defaulted receivable will be repaid prior to such date.
- In all cases under the risk-based capital requirements, the amount of risk based capital that must be held against a position should be limited to, in the case of positions in the trading book, the position's then market value, and, in the case of positions in the banking book, the lesser of the dollar amount of the capital for the position, and the total capital required for the entire pool in which such position is an interest.
   - Under the rules as now written, required capital may exceed the maximum possible loss on the position, i.e., a total write-off.
   - An example of the excessive capital that is proposed to be required in the trading book is a BB rated junior residential mortgage-backed securities tranche where the risk based capital would be calculated using VaR, Stressed VaR and the SSFA:
      - Under the SSFA, a junior tranche could receive a 100% or more risk based capital requirement (1250% risk weight), which is an assumption of at least a 100% loss.
      - The VaR and Stressed VaR capital requirements would be added *on top of* the 100% or more capital requirement from the SSFA, vastly exceeding the position's actual market value and potential for loss.
- Securitizations that transfer credit risk should be eligible for capital relief based on evidence of risk transfer, irrespective of their accounting treatment.
   - Accounting rules are a set of rules that apply to an entity's presentation of balance sheet and income, which can turn on issues not exclusively of transfer of risk, but other factors such as control.

  - o Basing eligibility for capital relief on the question of whether risk has in fact been transferred in substance precisely aligns with the need for more or less capital.

- GSE residential mortgage-backed securities should receive Level 1 status in the LCR so long as the U.S. Treasury supports the GSE's repayment obligations through the Preferred Stock Purchase Agreements.

  - o Residential mortgage-backed securities positions guaranteed by GSEs are now Level 2A HQLAs for purposes of the LCR. Level 2A HQLAs are subject to a 15% haircut for purposes of calculating the LCR and the total amount of Level 2A and 2B HQLAs that can be counted as part of the numerator cannot exceed 40% of the total numerator.

  - o The reason for being placed in Level 2A is that the U.S. Treasury's support for these mortgage-backed securities is not an explicit guaranty. In reality, the Fannie Mae and Freddie Mac mortgage-backed securities market is the second most liquid U.S. fixed income market, trailing only U.S. Treasuries, and averaging approximately $200 billion a day in trading volume.

- Certain high quality residential mortgage-backed securities and asset-backed securities should qualify as Level 2B assets in the LCR subject to the same haircuts and numerator percentage limits to which all Level 2B HQLAs are subject.

  - o Except for GSE residential mortgage-backed securities, no residential mortgage-backed securities or asset-backed securities currently qualify as HQLA for purposes of the LCR, no matter how high in credit quality or liquidity. Even in the EU, such bonds have some value as HQLAs.

  - o The liquidity characteristics of high quality residential mortgage-backed securities and asset-backed securities qualify them for inclusion as Level 2B HQLAs, just as certain corporate bonds so qualify.

Regulation AB II

- The SEC should review and rationalize the number of required data-fields for various types of asset-backed securities and residential mortgage-backed securities under Regulation AB II, and provide for a more flexible means of compliance.

- The required 270 data-fields for residential mortgage-backed securities have effectively shut-down public securitization transaction offerings and have forced many issuers to rely on private markets with the related increased costs and expense due to illiquidity. These requirements are unprecedented. GSE offerings include less than one-third of the number of required data-fields under Regulation AB II and, similarly, secondary mortgage loan portfolios trade in the normal course with significantly less asset-level data.
- The 66 data-fields for auto asset-backed securities have curtailed public issuance for smaller or more infrequent asset-backed securities issuers, are a barrier to entry for prospective first time issuers, and far exceed what market participants deem to be essential.
- While the regulation permits anonymization of certain data, both domestic and international privacy concerns remain materially unaddressed in the regulation.

- Regulation AB II should permit a comply or explain option to allow issuers to provide all data that are reasonably obtainable and available, and disclose why other data points are not being provided.
- The SEC should withdraw the proposed application of asset-level data and other requirements under Regulation AB II to private offerings, since the sophisticated investors active in such offerings do not need mandated disclosure.
- Regulation AB II should not have the required three-day waiting period in the offering process apply to active asset-backed securities sponsors with significant outstanding asset-backed securities and who are subject to reporting under the Exchange Act. There is no need for the 3-day waiting period for such a sponsor.

Credit Risk Retention

- The credit risk retention rules should permit other forms of retention, including permissible forms under the corresponding EU rules, contingent and unfunded support or retained interest on the underlying assets, as well as a simplified horizontal retention method for a securitization transaction.

  - These simple reforms would increase the competitiveness of U.S. financial markets without unduly limiting the effectiveness of the credit risk retention rule.

- The credit risk retention rules should be revised to make the included qualifying exceptions for commercial loans, commercial real estate and automobile loans workable and of practical utility.

  - None are used in the securitization markets to a material extent, which clearly attests to their overly prescriptive nature.

- The U.S. credit risk retention rule should include the exception for the Qualified CLO proposed by several trade associations, including SIFMA, in a letter to risk retention regulators, dated November 10, 2014.[17]

- Regulators should work to reduce conflicts between U.S. and European risk retention rules. These rules conflict in certain ways that impair U.S. access to global markets.

Derivatives: Margin Requirements for Securitizations

- Margin requirements for swaps used by securitization special purpose entities should be revised in the manner previously proposed by SIFMA and others[18] or otherwise be treated in substantially the same manner as swaps with non-financial end users.[19]

[17] Comment letter on risk retention proposed rule from SIFMA, the Loan Syndications & Trading Associations and Structured Finance Industry Group (Jan. 10, 2014) (link).

[18] Supplemental comment letter on margin requirements for securitization swaps from SIFMA (Nov. 24, 2014) (link); Comment letter on margin and capital requirements for covered swap entities from SIFMA (Nov. 24, 2014) (link); and Comment letter on margin and capital requirements for covered swap entities from SIFMA Asset Management Group (Nov. 24, 2014) (link).

[19] Id.

Qualified Mortgage Standards

- The CFPB should review and revise the QM standards for determining monthly debt and income (Appendix Q) to eliminate overly prescriptive and inflexible requirements, as well as provide needed clarity. This review should focus in particular on how lenders may rely on applicants' bank statements and various issues related to self-employed applicants.
- The CFPB should develop a responsive process to issue guidance to market participants, in the form of frequently asked questions documents or otherwise.

Volcker Rule: Application to Securitization

- Securitization structures and special purpose entities are neither hedge funds nor private equity funds, and should not be captured by the definition of covered fund in the Volcker Rule, as discussed in Chapter 4.

TRID

- The CFPB should reduce TRID complexity to shorten closing timelines, reduce costs, improve the customer experience, and increase secondary market liquidity. Among other things, this means that the CFPB should:
  - Clearly define the statutory authority under which particular TRID requirements and the associated liabilities have been promulgated.
  - Add flexibility to remedy minor errors.
  - Make penalties proportional to breaches.
  - Formally adopt the "Cordray Letter," which provides some protection for lenders and assignees against errors on early/estimated disclosures.[20]

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[20] Letter from Richard Cordray, Director, CFPB, to Mortgage Bankers Association (Dec. 29, 2015) (link).

- Allow lenders to re-baseline fees with a closing disclosure for delayed closings to remove a source of potential liability for lenders and assignees.
- Finalize the rule proposed in August 2016 that includes additional clarifications and direction requested in industry comments.

Chapter 10

PROMOTING EQUITY MARKET ISSUANCE

Relevant Agency

- SEC

Chapter 10 – Promoting Equity Market Issuance

A. Original Problem to be Remedied

Capital raising in the United States is governed by a framework that was first put in place more than 80 years ago. While there have been occasional regulatory and legislative efforts to update the framework, e.g., Securities Offering Reform in 2005 and the JOBS Act in 2012, capital markets participants, including investors, issuers, selling security holders and intermediaries, operate in a regulatory structure that has not kept pace with the revolutions in information and communications technologies that have transformed nearly every other aspect of U.S. commercial activity in the last few decades. At the same time, requirements have accreted over the years that have increased the regulatory burden for companies without equivalent benefits for investors and the capital markets. The intense focus on the Dodd-Frank Act since 2010—coming on the heels of the bursting of the dot-com bubble in 2000, the corporate scandals that led to the Sarbanes-Oxley Act, the mutual fund scandals in 2003 and then the financial crisis—has left little time or regulatory resources to invest in other areas and has kept the United States from modernizing its approach to capital markets.

U.S. financial markets are a critical source of financing for businesses. Unfortunately, the number of publicly listed companies in the United States has declined dramatically over the last 10 years, from 7,322 in 1996 to 3,671 in 2016.[1] Similarly, the number of new IPOs has also significantly decreased in that period, from 491 in 1996 to 84 in 2016, and dollars raised has similarly declined.

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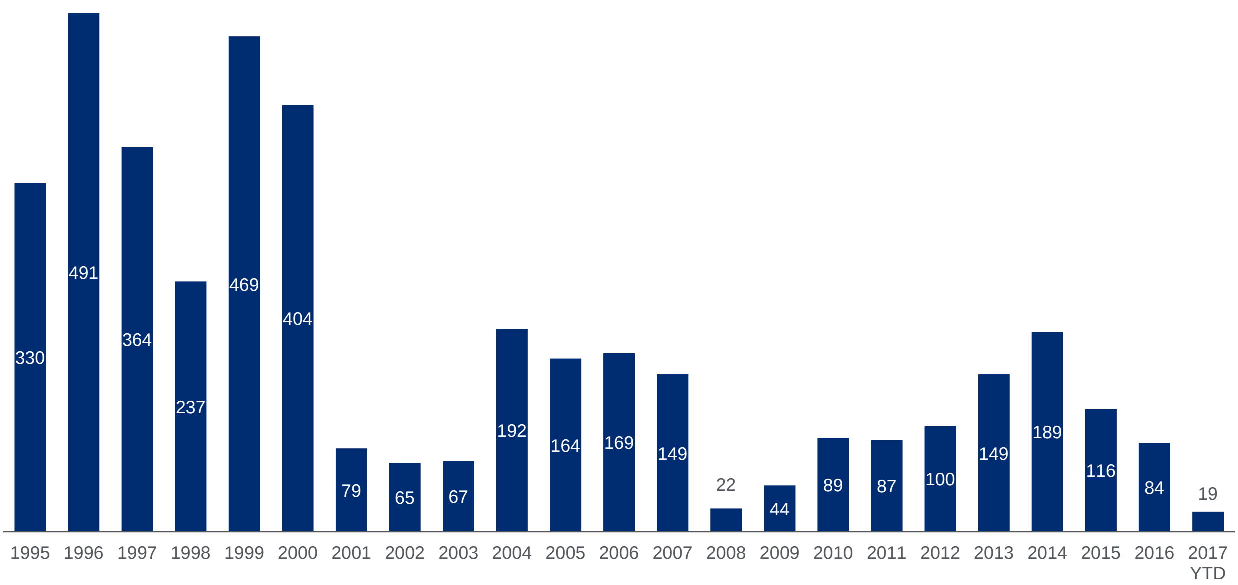
[1] CREDIT SUISSE GLOBAL FINANCIAL STRATEGIES, THE INCREDIBLE SHRINKING UNIVERSE OF STOCKS (Mar. 22, 2017) (link).

Figure 12

IPO Volume Has Declined . . .

All IPOs — By Number of Deals

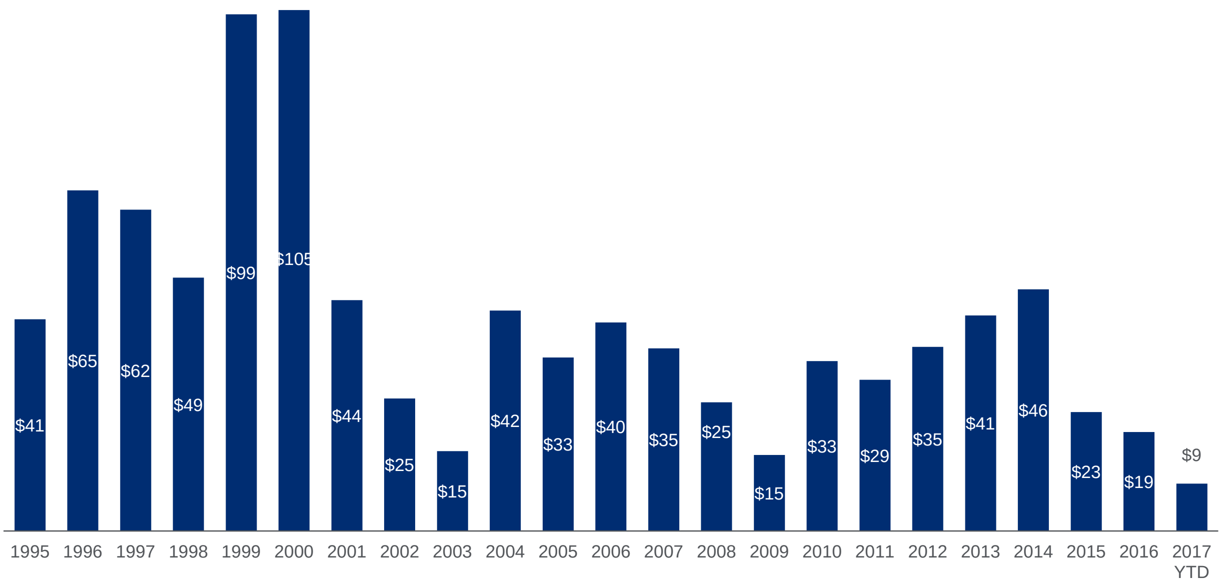


Source: Dealogic as of Apr. 5, 2017. Includes SEC Registered IPOs > $25 million. Excludes BDCs, SPACs, MLPs, CLEFs, REITs. (1) Excludes Alibaba IPO ($25 billion).

Figure 13

. . . As Have IPO Dollar Raised . . .

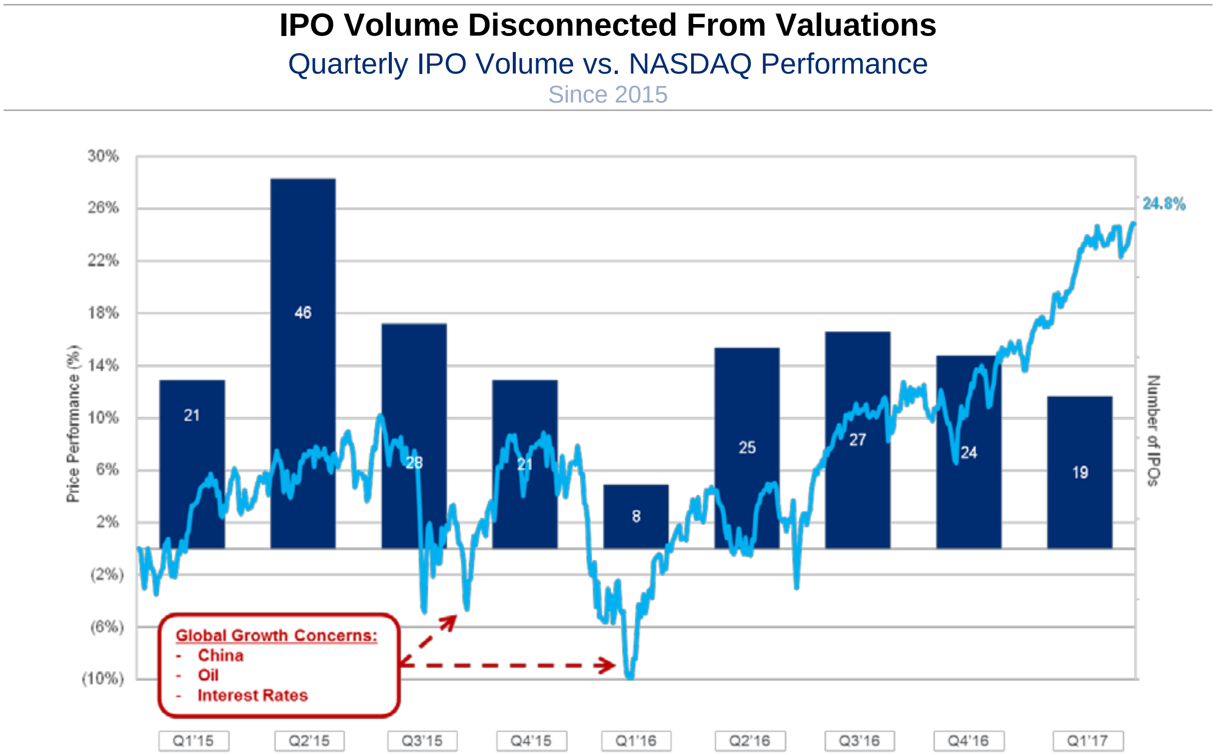
All IPOs — By Dollar Value Raised ($BN)



Source: Dealogic as of Apr. 5, 2017. Includes SEC Registered IPOs > $25 million. Excludes BDCs, SPACs, MLPs, CLEFs, REITs. (1) Excludes Alibaba IPO ($25 billion).

IPO volume has declined over the last nine quarters despite rising valuations.

Figure 14



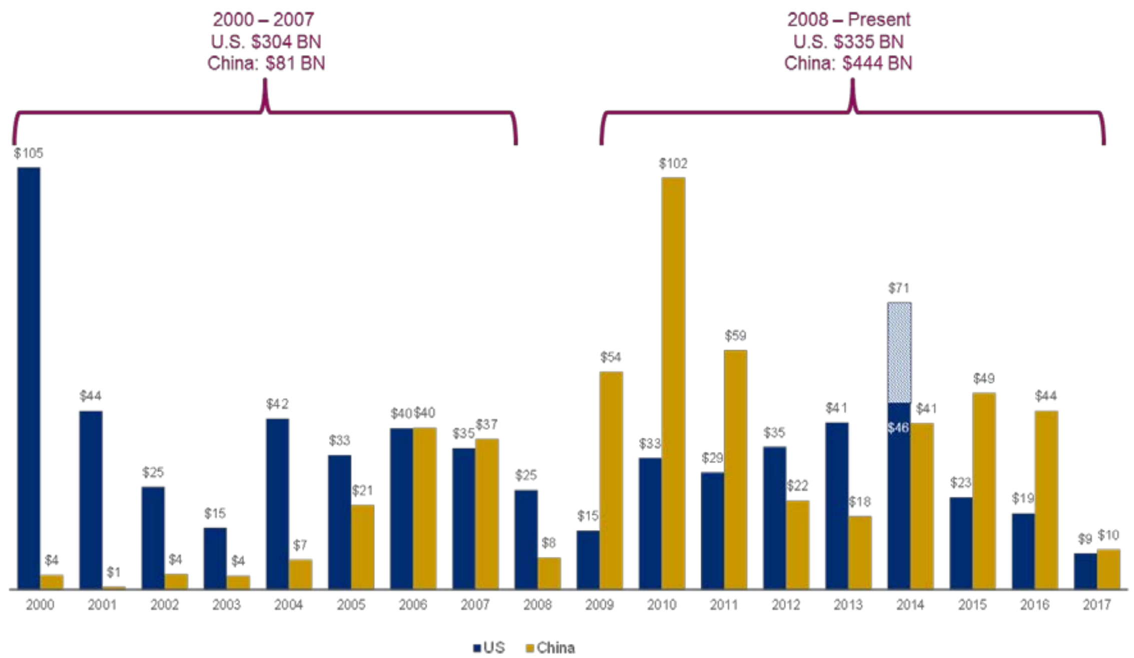
Source: Dealogic as of Apr. 5, 2017. Excludes REITs, CLEFs, SPACs, BDCs, MLPs, non US domiciled companies, and offerings < $25 million.

Chinese equity issuance now outpaces U.S. equity issuance.

Figure 15

Looking Ahead: Chinese Equity Issuance Outpaces U.S.

IPO Issuance USA vs. China ($BN)



Source: Dealogic as of Apr. 5, 2017. Excludes SPACs, REITs, BDCs, MLPs. ***US****: U.S. Listed SEC Registered IPOs > $25 million. Excludes BDCs, SPACs, MLPs, CLEFs, REITs. Shaded portion in 2014 represents Alibaba IPO ($25 billion).* ***China****: Chinese listed IPOs > $25 million. Excludes BDCs, SPACs, MLPs, CLEFs, REITs.*

Modernization and rationalization of the U.S. regulatory framework would help to reverse these trends by expanding access to the capital markets for innovative businesses, both small and large, thereby stimulating economic growth and job creation.

B. Need for Rebalancing

With the continuing rapid development of capital markets in competing financial centers such as London and Hong Kong, it is critical to the long-term health of the U.S. financial markets, and therefore the U.S. economy as a whole, for the aging regulatory framework to be reassessed. Core Principle (c) calls for fostering economic growth and vibrant financial markets. A rebalancing of U.S. securities legislation and regulations would

> "A renewed analysis of securities markets—where we are today, how we got here, and whether we should shift course—is long overdue."[2]
>
> *– Michael S. Piwowar, Acting Chair, SEC*

help to promote this goal by facilitating capital formation and access to equity markets.

Access to Public Capital Markets Is Too Restrictive (Core Principle (c))

The JOBS Act relaxed the prohibition on pre-filing offers to certain sophisticated investors by emerging growth companies. Permitting companies to file registration statements confidentially allows them to take the time often needed during the SEC review process to consider whether to proceed with an offering without disclosing trade secrets to the market. Allowing companies to test the waters with investors decreases the risk of launching an unsuccessful offering. Reducing the burden associated with preparing additional financial statements, and obtaining an audit with respect to additional annual financial statements, decreases the cost to companies of doing a public offering. Emerging growth companies have since 2012 taken advantage of these accommodations provided by the JOBS Act with positive effect. Larger companies, however, experience many of the same frictions that can deter efficient and effective capital raising. Extending these provisions to a broader set of companies would encourage yet more companies to raise capital in the U.S. financial markets as a means to finance business investment, spur greater economic activity and facilitate job creation.

> "What we see clearly today…is that the JOBS Act had a positive impact on companies, particularly those that have been eager and ready to go public after the 2008 financial crisis and only needed a slight push."[3]
>
> *– Edward S. Knight, Executive Vice President, General Counsel and Chief Regulatory Officer, Nasdaq*

The U.S. securities registration system affords smaller companies accommodations to ease frictions associated with capital raising that can serve to discourage many companies from accessing the U.S. public capital markets, including certain burdensome disclosure-related and SOX 404 requirements. The elimination of these same burdens for an expanded number of companies would have significant upside potential for the U.S. public capital markets and economy generally. Eliminating the requirements to use Forms S-3/F-3 will by facilitating subsequent public

[2] Michael S. Piwowar, Acting Chairman, FDIC, New Special Study of the Securities Markets: Keynote Address (Mar. 23, 2017) (link).

[3] *The JOBS Act at Five: Examining Its Impact and Proposals to Further Enhance Capital Formation: Hearing Before the H. Subcomm. on Financial Services*, 115th Cong. (Mar. 22, 2017) (statement of Edward S. Knight, Executive Vice President, General Counsel and Chief Regulatory Officer, Nasdaq, Inc.) (link).

offerings make entering the U.S. public capital markets via an IPO more attractive for all issuers.

Business development companies also do not benefit from many of the accommodations afforded to smaller reporting companies, and in many cases other reporting companies more generally. Because business development companies generally facilitate capital formation for smaller companies, eliminating the many restrictions applicable to them would in turn benefit smaller companies by increasing the investment dollars available to them. Business development companies also create investment opportunities for retail investors. Lastly, only S-3/F-3 eligible issuers benefit from other accommodations not applicable to all reporting companies, including insulating securities analysts from liability for research coverage that might otherwise be deemed an offering of securities. Issuers and investors benefit from increased research, which provides greater access to information to facilitate more informed, and therefore more effective, capital raising and investment decisions.

Private Investment and Secondary Market Trading In Restricted Securities Should Be More Easily Accessible (Core Principle (c))

While there is significant room to ease the burdens on companies seeking to raise money in the U.S. public capital markets, private companies equally should be able to more easily access capital from willing investors. Promoting capital formation at each stage of a company's life cycle creates the much-needed on-ramp to facilitate growth and job creation. Eliminating unnecessary roadblocks, such as certain elements of the bad actor prohibition in Regulation D, and expanding the potential universe of investors that can contribute capital to private companies would directly increase investment in the U.S. economy and would also allow companies to grow more quickly. In some cases these changes will put companies in a position where, combined with the reform suggestions above, they may consider raising capital publicly at an earlier time. Promoting investment in private companies also fosters the development of technology and other productivity enhancing innovations that so many private companies deliver to the U.S. economy.

Secondary Market Public Resale Market Liquidity Should be Enhanced (Core Principle (c))

Facilitating secondary market public resales provides a more liquid exit for investors in U.S. public companies. Secondary market liquidity also creates a positive feedback loop to help reduce an issuer's cost of capital. Amending Rule 144 to eliminate complex and unnecessary resale requirements would both encourage more investment in U.S. public companies, and early stage companies that wish to go public, and in turn encourage more companies to consider going public.

Investment In the Municipal Securities Markets Should Be Encouraged (Core Principle (c))

Municipal securities are a critical mechanism for state and local governments to finance their infrastructure needs and other obligations. Overhauling the nation's aging infrastructure is a priority of the current administration, and infrastructure investment will create new jobs both directly through construction and development and indirectly through its follow-on effects on economic output. S.828 would amend the FDIA and require federal banking regulators to treat certain municipal obligations as Level 2B liquid assets under their liquidity coverage ratio rules. By allowing these obligations to be treated as HQLA, increased bank investment in municipal securities can be encouraged, as discussed in Chapter 3.

C. Proposed Recommendations

- Extend several JOBS Act accommodations that are available for emerging growth companies to all issuers of public securities:
  - Amend Sections 6(e) of the Securities Act to permit all issuers, regardless of size and so long as they were not public companies for at least 3 months before the initial confidential filing, to file confidentially.
  - Amend Section 5(d) of the Securities Act to permit all issuers, in the context of IPOs, to engage in oral or written communications with potential investors that are QIBs or institutional accredited investors to test the waters and determine whether such investors might have an interest in a contemplated IPO.

  - Amend Rule 163 under the Securities Act to allow prospective underwriters, authorized by the issuer, to make offers of WKSI securities in advance of filing any registration statement without those offers violating Section 5 of the Securities Act.

  - Amend Section 7(a) of the Securities Act and Section 13(a) of the Exchange Act to permit all first-time registrants to submit two rather than three years of audited financial statements in their Securities Act registration statements and to limit required selected financial data, including in subsequent Exchange Act reports, to the periods included in such registration statement.

  - Amend Section II.C in the General Instructions to form S-1 and, when revised, the equivalent provision in form F-1 to permit all issuers to omit from pre-marketing filings audited financial statements that will not ultimately be required at the time of marketing.

- Reduce burdens on issuers of accessing the public capital markets:

  - Amend the definition of smaller reporting company to raise the public float threshold from $75 million to $250 million.

  - Exempt all smaller reporting companies and give all first-time registrants a two-year annual report grace period from SOX 404 requirements.

  - Amend Forms S-3 and F-3 to permit all issuers to use Form S-3 or Form F-3 after their first post-IPO 10-K or 20-F and eliminate all other S-3/F-3 eligibility requirements except being up to date with all Exchange Act filings.

  - Permit business development companies to take advantage of a number of accommodations on the same basis as the other issuers to which they apply:

    - WKSI status and automatic shelf registration.

    - Rule 415 and shelf registration.

    - Incorporation by reference.

    - Research and communications safe harbors provided by Rules 134, 138, 139, 163, 163A, 164, 168, 169, 433.

        - Access equals delivery provided by Rules 172 and 173.
        - Prospectus and prospectus supplement provisions of Rule 424(b).
        - Revise Rule 418(a)(3) to provide that business development companies meeting Form S-3 eligibility requirements are exempt from the requirement to provide the SEC with reports or memoranda relating to their business, operations or products for the past 12 months upon request.

- Promote private investment and secondary market trading in restricted securities
    - Expand Rule 139 to provide that continuing coverage by research analysts of any issuer, as opposed to only those that qualify for Form S-3/F-3, would not be deemed to constitute an offer for sale of a security of such issuer before, during or after an offering by such issuer.
    - Amend the definition of accredited investor in Rule 501 under the Securities Act to include the following criteria which, if met, would qualify an investor as accredited as an alternative to the existing income/net worth tests:
        - Any investor currently licensed or registered as a broker or investment adviser by the SEC, FINRA, or an equivalent self-regulatory organization, or a state division responsible for licensing or registration of individuals in connection with securities activities.
        - Require the SEC to develop additional objective standards based on education, job experience and professional knowledge or certifications, or alternatively develop such standards with the financial sector for draft legislation.
    - Revise the substance and scope of bad actor disqualification to;
        - Limit the types of actions that cause disqualification to material violations of the securities laws.
        - Eliminate disqualifications based on actions of affiliates (other than subsidiaries), directors, officers and beneficial owners.
    - Amend Rule 144 under the Securities Act to:

        - Establish 20% ownership as the presumptive dividing line between nonaffiliated and affiliate status for shareholders that may be deemed to be affiliates by virtue of their share ownership alone.
        - Eliminate 3-month lag post-exiting affiliate status.
        - Reduce holding period for restricted securities of reporting issuers from 6 to 3 months.
        - Shorten period that must lapse after an issuer's IPO before Rule 144 becomes available to 30 or 60 days.
- Promote greater liquidity in municipal securities.
    - Amend the FDIA to require the appropriate federal banking agencies to treat municipal bonds that are investment grade and liquid and readily marketable as 2B securities for the LCR Rule.

Chapter 11

ENHANCED PRUDENTIAL STANDARDS FOR FOREIGN BANKING ORGANIZATIONS

Relevant Agency

- FRB

Chapter 11 – Enhanced Prudential Standards for Foreign Banking Organizations

A. Original Problem to be Remedied

After the financial crisis, the Federal Reserve issued a regulation that imposes significant enhanced prudential standards on foreign banking organizations and their U.S. operations.[1] The Federal Reserve justified these enhanced prudential standards for foreign banking organizations and the significant regulatory and compliance burdens associated with these enhanced prudential standards based on several factors, including:

- Changes in foreign banking organizations' business models, such as increased concentration, interconnectedness and complexity of foreign banking organizations' U.S. operations and shifts, preceding the financial crisis, of some foreign banking organizations' U.S. operations from being net funding recipients of parent organizations to net funding providers, accompanied by increased reliance on short-term wholesale U.S. dollar funding;
- Developments during the financial crisis, including that some foreign banking organizations' reliance on cross-border funding flows and swap markets proved destabilizing, resulting in deleveraging and, in some cases, the Federal Reserve's providing considerable amounts of liquidity to both the U.S. branches and U.S. broker-dealer subsidiaries of foreign banking organizations; and
- The Federal Reserve's more limited access to information on the global operations of foreign banking organizations in contrast to U.S.-based banking organizations.

The Federal Reserve took a tiered approach to the application of enhanced prudential standards to foreign banking organizations and their U.S. operations by increasing applicable enhanced prudential standards,

[1] The Federal Reserve's Final Enhanced Prudential Standards Rule (Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240 (Mar. 27, 2014)) implements these enhanced prudential standards for foreign banking organizations. 12 C.F.R. § 252.

including capital, liquidity, stress testing and risk management requirements, in stringency based on the size and U.S. footprint of the foreign banking organization:

- ***Foreign Banking Organizations Subject to the U.S. IHC Requirement***

  Approximately 17[2] foreign banking organizations hold $50 billion or more in U.S. non-branch assets and are subject to the most stringent regulatory and compliance burdens, including the U.S. IHC requirement. If a foreign banking organization is subject to the U.S. IHC requirement, it must hold its ownership interests in substantially all of its U.S. subsidiaries through a U.S. intermediate holding company, or U.S. IHC. Foreign banking organizations subject to the U.S. IHC requirement incurred significant costs in connection with the restructuring needed to establish a U.S. IHC by July 1, 2016. Implementation and related costs are, at least in part, still ongoing.

  In addition to having to restructure their U.S. operations to implement the U.S. IHC requirement, significant and costly enhanced prudential standards apply to these foreign banking organizations, including the following:

  - Risk-based capital and leverage requirements applied at the U.S. IHC level as well as compliance with capital stress testing and capital planning requirements, in each case in the same manner as U.S. BHCs;

  - Requirement to maintain a 30-day liquidity buffer for the U.S. IHC and a 14-day U.S. liquidity buffer for U.S. branches and agencies, in each case based on internal liquidity stress tests that need to meet certain standards; and

  - Umbrella supervision of their U.S. operations, including examination and inspection, by the Federal Reserve.

[2] Estimates of the number of foreign banking organizations subject to enhanced prudential standards are as of March 2014, based on the Final Enhanced Prudential Standards Rule. Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,314 (Mar. 27, 2014).

- ***Foreign Banking Organizations Without a U.S. IHC***

  Approximately 85 additional foreign banking organizations fall into the scope of the enhanced prudential standards regulation without having to comply with the U.S. IHC requirement. These foreign banking organizations are, however, subject to stringent enhanced prudential standards, including liquidity, stress testing, capital certification and risk-management standards, based on their size and U.S. footprints. These foreign banking organizations include:

  - Approximately 7 foreign banking organizations that are foreign banking organizations with large U.S. operations because they hold $50 billion or more in U.S. assets in their U.S. subsidiaries, branches and agencies. These foreign banking organizations need to comply with various enhanced prudential standards requirements, the most significant of which are the requirements to maintain a 14-day U.S. liquidity buffer for U.S. branches and agencies based on internal liquidity stress tests that meet certain standards and to conduct capital stress tests annually on a consolidated basis that meet certain standards and provide the Federal Reserve with a summary of the results.

  - Approximately 102 foreign banking organizations are foreign banking organizations with limited U.S. footprints that are subject to certain enhanced prudential standards:

    - Foreign banks are foreign banking organizations with total consolidated assets of $50 billion or more but combined U.S. assets of less than $50 billion; they are subject to various enhanced prudential standards, including a requirement to annually conduct Basel-compliant internal liquidity stress tests and report the results to the Federal Reserve; and

    - Mid-size foreign banks are foreign banking organizations with more than $10 billion but less than $50 billion in global assets and a certain U.S. nexus; they are subject to less-burdensome requirements.

The varying degrees of enhanced prudential standards are applied to all foreign banking organizations subject to the regulation notwithstanding the fact that these foreign banking organizations are subject to home-country regulation, such as local implementation of Basel III requirements, at the consolidated parent-company level, which includes the foreign banking organizations' U.S. operations, that is generally equivalent to or in some cases more stringent than U.S. prudential standards for an institution of the same size and that the U.S. subsidiaries of foreign banking organizations, such as U.S. broker-dealers or banks, are already subject to direct regulation within the United States, such as FINRA supervision of a broker-dealer and OCC supervision of a national bank subsidiary, that is the same as for U.S. organizations of the same size.

B. Need for Rebalancing

The U.S. operations of foreign banking organizations have long played an important role in U.S. financial markets and the U.S. economy.[3] Foreign banking organizations are significant creators of jobs, with the largest 10 foreign banking organizations by U.S. IHC asset size employing more than 100,000[4] employees in the United States. Foreign banking organizations are 8 of the top 20 U.S. loan bookrunners for 2017 YTD, with a 25% combined market share.[5] For 2016, foreign banking organizations were 4 of the top 10 U.S. equity capital markets bookrunners; 4 of the top 10 U.S. debt capital markets bookrunners; and 3 of the top 10 U.S. merger and acquisition advisors.[6]

Despite the importance of the U.S. operations of foreign banking organizations for job creation, the U.S. economy and the U.S. financial market, regulatory burdens on the U.S. financial sector in general and on foreign banking organizations in particular have consistently increased in the aftermath of the financial crisis and with the enactment of the Dodd-Frank Act in 2010. This increase of regulatory burdens coincided with a decrease of foreign banking organization activity in the United States, particularly as implementing regulations have been issued. As illustrated in the diagram below, the assets of broker-dealers affiliated with foreign

[3] Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *Foreign Banks in the United States and U.S. Banks Abroad*, FINANCIAL REGULATION: LAW AND POLICY 721-750 (2016).

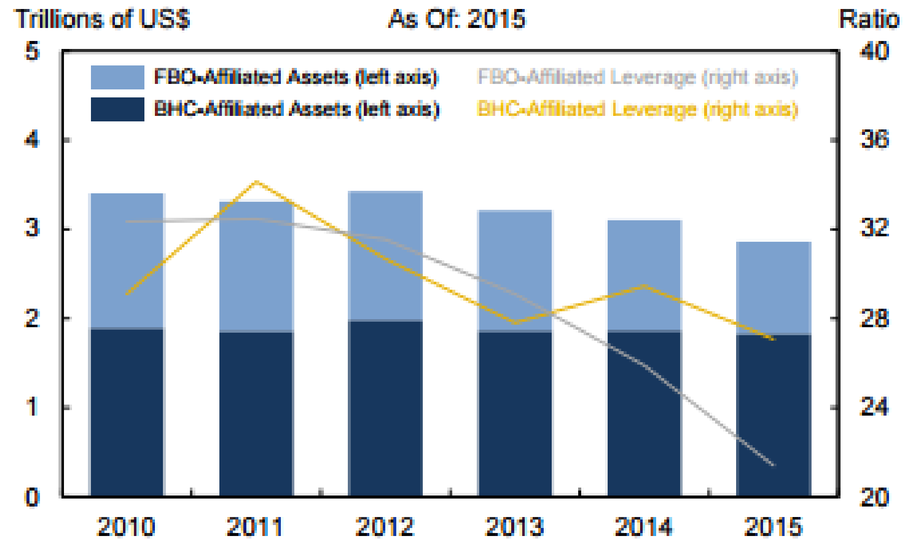
[4] Estimate based on publicly available information as of December 31, 2016 for Barclays PLC, BNP Paribas, Credit Suisse Group AG, Deutsche Bank Aktiengesellschaft, HSBC Holdings plc, Mitsubishi UFG Financial Group, Royal Bank of Canada, Banco Santander, S.A., The Toronto-Dominion Bank and UBS Group AG.

[5] BLOOMBERG, BOOKRUNNER RANKING: US LOANS, 2017 YTD (Apr. 5, 2017).

[6] WALL ST. J., DEALLOGIC INVESTMENT BANKING SCORECARD (2017).

banking organizations have generally declined since 2010, while the assets of broker-dealers affiliated with U.S. BHCs generally remained consistent over the same period of time. For the reasons outlined below, the enhanced prudential standards imposed on foreign banking organizations make further U.S. investments by foreign banking organizations less attractive.

Figure 16 – Broker-Dealer Assets by Affiliation



Source: 2016 FSOC Annual Report.

SIFMA supports the appropriate regulation of foreign banking organizations that are active in the United States in order to ensure the strength, stability and competitiveness of U.S. financial markets. SIFMA believes, however, that rebalancing the regulatory requirements imposed on foreign banking organizations will help reverse the trend of declining activity of foreign banking organizations in the United States by better aligning the existing enhanced prudential standards regulation for foreign banking organizations with the Core Principles of fostering economic growth and vibrant financial markets through better regulatory impact analysis (Core Principle (c)), enabling U.S. firms to compete in domestic and international markets (Core Principle (d)), and ensuring that regulation is efficient, effective and appropriately tailored (Core Principle (f)).

With regard to the U.S. IHC requirement and the application of other enhanced prudential standards to foreign banking organizations, the problems predicted in comments to the proposed rule have come to pass. Perhaps most significantly, the European Commission recently proposed legislation that, among other things, would impose IHC requirements in the European Union on certain large non-EU-based financial companies, which would include many U.S. BHCs.

Overlapping and duplicative rules providing no recognition of parent support or home-country enhanced prudential standards have unnecessarily trapped capital and liquidity and discouraged investment in the U.S. economy. These effects underscore the need to rebalance the enhanced prudential standards applicable to foreign banking organizations, and for U.S. regulators to better engage and coordinate with their foreign counterparts in the European Union and elsewhere, for the reasons detailed below. There should be a pause to take stock of regulations not yet fully implemented or adopted, as waiting until regulations are actually implemented before assessing their impact imposes unnecessary costs on the private sector, to the detriment of job creation, the U.S. economy and U.S. financial markets.

Enhanced Prudential Standards for Foreign Banking Organizations Do Not Foster Economic Growth and Vibrant Financial Markets in the United States (Core Principle (c))

The enhanced prudential standards applicable to foreign banking organizations do not foster economic growth and vibrant financial markets in the United States as required by Core Principle (c) for the following reasons:

First, foreign banking organizations subject to the U.S. IHC requirement and the related capital and liquidity enhanced prudential standards applied at the U.S. IHC level are constrained in their ability to allocate capital and liquidity when, where and as needed across their organizations. Similar to their U.S. counterparts with global operations, internationally active foreign banking organizations manage their capital and liquidity on a consolidated basis, flexibly shifting financial resources within their organizations to the locations of the highest and best use, most notably to particular geographic locations or business operations undergoing financial or market stress. For foreign banking organizations subject to the U.S. IHC requirement, the application of capital and liquidity enhanced prudential standards at the U.S. IHC level creates the risk, however, that capital and liquidity will be trapped in the U.S. IHC or its subsidiaries, thus impeding a foreign banking organization's ability to appropriately manage its operations, redeploy financial resources nimbly across its international operations and respond appropriately to stresses in markets and businesses worldwide.[7]

Second, for foreign banking organizations subject to the U.S. IHC requirement, enhanced prudential standards applicable at the U.S. IHC level duplicate capital, liquidity and stress testing requirements. This is because these foreign banking organizations are subject at a consolidated level to regulation implementing Basel III requirements, including capital, liquidity and stress-testing requirements, in their home-country jurisdictions. In fact, under the enhanced prudential standards, the Federal Reserve requires these foreign banking organizations to certify that they are subject to home-country stress tests and to provide the Federal Reserve with a report on their home-country capital stress tests. The enhanced prudential standards imposed under the Federal Reserve's regulation add a second layer of capital, liquidity and stress-testing requirements, because the foreign banking organizations' U.S. operations are already included and appropriately reflected in home-country prudential standards applied at the foreign banking organization's parent level on a consolidated basis. In addition, certain key home-country jurisdictions of foreign banking organizations subject to the U.S. IHC requirement already impose or are in the process of imposing heightened prudential standards that are as strict as or, in some cases, even stricter than, those imposed by U.S. regulators on U.S. G-SIBs.[8] A second layer of

[7] Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,266, 17,314 (Mar. 27, 2014) (noting that the final rule "could incrementally increase costs and reduce flexibility of internationally active banks that primarily manage capital and liquidity on a centralized basis").

[8] For example, under Swiss law, Swiss G-SIBs are subject to rigorous capital and TLAC requirements, pursuant to which they have to build combined CET1, AT1 and other TLAC of 28.6% of risk-weighted assets, which is above the standards required by the FSB and the United States. Under the EU Capital Requirements Regulation, or EU Capital Requirements Regulation, Eurozone banks are subject to comprehensive capital and liquidity standards. The European Commission recently proposed amendments to further heighten these standards, including by imposing a binding leverage ratio and by introducing new standards on TLAC for Eurozone G-SIBs, which will require those institutions to have more loss-absorbing and recapitalization capacity, tackle interconnectedness in the global financial markets and further strengthen the EU's ability to resolve failing G-SIBs while minimizing risks for taxpayers. European Commission Proposal 2016/0360 (Nov. 23, 2016).

enhanced prudential standards relating to the U.S. IHC is therefore unnecessary, time-consuming and costly.[9]

Third, duplicative enhanced prudential standards at the U.S. IHC level have the practical effect of amplifying the enhanced prudential standards for foreign banking organizations subject to the U.S. IHC requirement. This effect occurs because a foreign banking organization that is subject to home-country equivalents to enhanced prudential standards at the parent level, which includes its U.S. operations, and enhanced prudential standards at the U.S. IHC level must meet enhanced prudential standards at *each* level, rather than just at *both* levels on a consolidated basis. As a consequence, complying with the enhanced prudential standards at the U.S. IHC level will, for example, require foreign banking organizations to maintain, or "pre-position," capital and liquidity buffers in the United States in excess of the capital and liquidity levels that would otherwise apply on a consolidated basis. As a result of these enhanced prudential standards, foreign banking organizations subject to the U.S. IHC requirement are hindered from fully exploring their growth and job-creation potential in the United States, and additional U.S. investments are disincentivized, with particularly adverse effects likely in those sectors in which foreign banking organizations are most active, such as syndicated lending[10] as well as equity and debt capital markets.[11]

Finally, similar to foreign banking organizations subject to the U.S. IHC requirement, foreign banking organizations without a U.S. IHC are subject to additional or duplicative U.S. liquidity, capital and liquidity stress-testing enhanced prudential standards that are unnecessary in light of the enhanced prudential standards imposed on their foreign banking organization parent companies on a consolidated basis in the parents' home-country

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[9] For example, these foreign banking organizations are required to comply with U.S. stress-testing requirements on an ***annual*** basis, whereas for Eurozone banks, E.U.-wide stress testing requirements are conducted by the European Banking Authority on a ***biennial*** basis, thus requiring Eurozone foreign banking organizations to conduct stress tests solely for purposes of reporting to the Federal Reserve, which is burdensome, time-consuming and costly – even though their home-country regulator has determined that a less-frequent basis is more appropriate.

[10] THOMSON REUTERS, US SYN LOANS (R11) (Apr. 5, 2017) (noting that four foreign banking organizations—Barclays, Deutsche Bank, Credit Suisse and RBC—are among the top ten bookrunners of U.S. syndicated loans for 2017 to date).

[11] WALL ST. J., DEALLOGIC INVESTMENT BANKING SCORECARD (2017).

jurisdictions. For example, foreign banking organizations with large U.S. operations[12] are required to:

- Maintain a liquidity buffer with respect to their U.S. branches and agencies, which traps liquidity in the United States and potentially prevents these foreign banking organization from allocating liquidity when, where and as needed; and
- Provide annual reports to the Federal Reserve describing the procedures for conducting, and summarizing the results of, their stress tests in the home country, if these foreign banking organizations have a U.S. branch or agency.

These are examples of enhanced prudential standards that generate significant compliance burdens that are unnecessary in light of home-country liquidity requirements and supervision of stress testing, and that are inappropriately intrusive on foreign supervision of foreign banking organizations at the consolidated level, which includes foreign banking organizations' U.S. operations. Enhanced prudential standards duplicative of home-country requirements make business activities in the United States less attractive for foreign banking organizations without a U.S. IHC because they generate unnecessary compliance burdens. More importantly, the U.S. IHC requirement acts as a *de facto* cap on U.S. growth for these foreign banking organizations in order to avoid crossing the $50 billion threshold at which they would be required to create a U.S. IHC.

SIFMA supports effective capital, liquidity and stress-testing enhanced prudential standards as an important component of ensuring financial stability but excessive requirements can chill job creation and credit provision and slow economic growth.[13] Foreign banking organizations subject to the U.S. IHC requirement are faced with the prospect that they will have to maintain more consolidated capital and liquidity than would be required without a U.S. IHC and that investments in their U.S. operations will become trapped in the United States and only returned to the foreign

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[12] A foreign banking organization that holds $50 billion or more in U.S. assets in its U.S. subsidiaries, branches and agencies.

[13] MCKINSEY GLOBAL INSTITUTE, FINANCIAL GLOBALIZATION: RETREAT OR RESET? 34 (Mar. 2013) (noting that ring-fencing local subsidiaries of foreign banks "leads to 'trapped pools of capital and liquidity,' . . . reduces the overall banking group's lending capacity and limits the ability to use deposit overhangs in one country for lending in another") (link).

parents or shifted to support non-U.S. operations with some difficulty. The enhanced prudential standards, in particular the U.S. IHC requirement, discourage foreign banking organizations without a U.S. IHC from expanding their U.S. operations and further investing in the United States, given the need to restructure their operations and the increased regulatory burden and costs of forming and maintaining a U.S. IHC. A foreign banking organization with nearly $50 billion in U.S. non-branch assets may be hesitant to increase its investments in the United States if, as a result of crossing the $50 billion threshold, it will become subject to a host of additional regulatory requirements, including the onerous requirement to form, and reorganize its existing U.S. operations underneath, a U.S. IHC.

For the foregoing reasons, SIFMA believes that the enhanced prudential standards imposed on foreign banking organizations by the Federal Reserve's regulation, including the U.S. IHC requirement, are inconsistent with Core Principle (c).

Application of Enhanced Prudential Standards to Foreign Banking Organizations May Make It Harder for U.S. Banking Organizations to Operate Internationally (Core Principle (d))

Most worrisome for U.S. banking organizations, the enhanced prudential standards imposed on foreign banking organizations, in particular the U.S. IHC requirement, reject well-established and generally successful models of international coordination and cooperation in the regulation of internationally active banking organizations in favor of a siloed, national approach. The United States remains the world's most important financial market, and the Federal Reserve plays a leading role in the international regulatory community. By signaling that the Federal Reserve will not rely on cooperation with foreign regulators to ensure the stability of the U.S. financial system, and instead implicitly endorsing a ring-fencing approach, the U.S. IHC requirement and the related enhanced prudential standards encourage foreign regulators to adopt comparable ring-fencing requirements of their own, instead of respecting decisions by the home-country regulator. The likely result of such a proliferation of ring-fencing requirements would be an increasingly fragmented international regulatory system, which undercuts international efforts to coordinate regulation and promote financial stability, and is detrimental to both U.S. banking organizations and foreign banking organizations. Comments on the Federal Reserve's proposed rule cautioned about this potential deleterious consequence,[14] and such warnings should have been heeded.

The European Commission has already proposed requiring certain non-EU banking organizations, including U.S. BHCs, to hold certain EU subsidiaries through an "intermediate EU parent undertaking"—i.e., an EU IHC.[15] This proposal is widely regarded as having been adopted in response to the U.S. IHC requirement.[16] If adopted, this proposal would require many internationally active U.S. banking organizations to restructure their overseas operations—incurring substantial costs in the process—and, in all likelihood, to comply with capital and liquidity requirements that will result in the pre-positioning of capital and liquidity overseas.[17] U.S. banking organizations are generally not yet subject to intermediate holding company requirements and related sub-consolidated-level prudential regulation in local jurisdictions overseas. Much as the U.S. IHC requirement traps foreign banking organizations' capital and liquidity in the United States, however, any such future requirements imposed in the EU or elsewhere would trap U.S. banking organizations' capital and liquidity abroad, significantly increasing costs and reducing the profitability of U.S. banking organizations, as well as hampering their ability to flexibly deploy resources to the United States in times of stress.[18]

For the foregoing reasons, SIFMA believes that the U.S. IHC requirement and application of enhanced prudential standards at the U.S. IHC level thus not only could undermine U.S. financial stability,[19] but, inconsistent with

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[14] Letter from Michel Barnier, Member, European Commission, to Ben Bernanke, Chair, Fed. Reserve (Apr. 18, 2013) (warning that the U.S. IHC requirement could "spark a protectionist reaction from other jurisdictions").

[15] European Commission Proposal 2016/0364, 12, 23–24 (Nov. 23, 2016) (proposed Article 21b).

[16] Laura Noonan & Jim Brunsden, *US Banks Face Clash Over EU Regulations*, FINANCIAL TIMES (Dec. 4, 2016) (link); Alex Barker & Jim Brunsden, *EU to Retaliate Against US Bank Capital Rules*, FINANCIAL TIMES (Nov. 21, 2016) (link).

[17] Letter from The Clearing House, American Bankers Association & The Financial Services Roundtable to the Federal Reserve on proposed rules implementing Sections 165 and 166 of the Dodd-Frank Act 4–6 (Apr. 30, 2013) (link).

[18] 79 Fed. Reg. 17,266, at 17,269 (noting that the "Board has considered the possibility that the proposal may affect the environment for U.S. banking organizations operating overseas").

[19] Letter from John L. Thornton, Hal S. Scott & R. Glenn Hubbard, Committee on Capital Markets Regulation, to Valid Dombrovskis, Vice President for Financial Stability, (….continued)

Core Principle (d), also foster an international environment that will ***not*** "enable American companies to be competitive with foreign firms in domestic and foreign markets." The arguments above also demonstrate that the enhanced prudential standards imposed on foreign banking organizations are inconsistent with Core Principle (f), which, as the next section discusses in more detail, requires regulation to be efficient, effective and appropriately tailored.

Enhanced Prudential Standards Imposed on Foreign Banking Organizations Are Not Efficient, Effective and Appropriately Tailored (Core Principle (f))

The enhanced prudential standards imposed on foreign banking organizations, including the U.S. IHC requirement and the related capital, liquidity and stress testing requirements at the U.S. IHC level, are also inefficient, ineffective and inappropriately tailored to the business model of many foreign banking organizations for the following reasons:

First, the U.S. operations of many of the larger foreign banking organizations are primarily focused on broker-dealer activities as opposed to general banking activities in the case of U.S. BHCs. The fact that many of the larger foreign banking organizations primarily focus on broker-dealer activities in the United States makes the application of enhanced prudential standards that are intended for organizations with banking comprising the bulk of their activities at the U.S. subsidiary level particularly burdensome and not appropriately tailored, as called for by Core Principle (f).[20]

Second, the imposition of enhanced prudential standards, in particular the U.S. IHC requirement and enhanced prudential standards at the U.S. IHC level, on foreign banking organizations with U.S. subsidiary operations that

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(continued….)

Financial Services and Capital Markets Union, European Commission, and Hon. Daniel K. Tarullo, Governor, Fed. Reserve on Proposal for a Directive of the European Parliament and the Council Amending Directive 2013/36/EU 3 (Jan. 6, 2017); Letter from R. Glenn Hubbard, John L. Thornton & Hal S. Scott, Committee on Capital Markets Regulation, to the Federal Reserve on Enhanced Prudential Standards Proposed Rule 6–7 (Apr. 24, 2013).

[20] In the preamble to the Enhanced Prudential Standards Final Rule, the Federal Reserve stated that commenters asserted that "the U.S. intermediate holding companies of several foreign banking organizations would be comprised of over 90% U.S. or more recent broker-dealer subsidiary assets." 79 Fed. Reg. 17,266, at 17,282.

are predominantly broker-dealer activities is not necessary because U.S. broker-dealer subsidiaries of foreign banking organizations are already subject to stringent oversight by the SEC and FINRA and capital requirements that are specifically tailored to U.S. broker-dealers. Enhanced prudential standards applicable to foreign banking organizations are intended to mitigate the risks posed to U.S. financial stability by the U.S. activities of these foreign banking organizations, they have, in reality, a negative impact on job creation, U.S. economic growth and financial markets that outweighs any potential benefits.

Third, the application of liquidity stress-testing and other enhanced prudential standards to foreign banking organizations ignores how the foreign parent organization of a foreign banking organization can serve as, and historically has been, a source of strength to its U.S. operations. In this respect, the U.S. operations of a foreign banking organization are unlike those of a standalone top-tier U.S. BHC, which has no further parent which can serve as an additional source of strength during times of stress. It is therefore inappropriate to impose requirements on the U.S. operations of a foreign banking organization predicated on ring-fencing; i.e., without accounting for the ability of the foreign banking organization's U.S. operations to access support from their foreign parent, or based on the unwarranted assumption that no parent support would be forthcoming in a stressed situation.[21]

Finally, if a U.S. IHC is the same size as a U.S. regional bank or other mid-sized U.S. firm, the U.S. IHC should be regulated like a regional bank or other mid-sized U.S. financial institution, and not itself be subject to requirements appropriate to a G-SIB on account of its parent's total assets. The current asset thresholds triggering enhanced prudential standards for

[21] For example, liquidity stress-testing and liquidity buffer requirements applicable to foreign banking organizations treat inter-affiliate cash flows punitively, based on the assumption that foreign banking organization parent entities might not support their U.S. operations in times of stress. 12 C.F.R. § 252.157; 79 Fed. Reg. 17,266, at 17,294 (noting that, because "[t]he Board believes that the U.S. and non-U.S. operations of a foreign banking organization could face simultaneous funding pressures, which could hinder the ability of the foreign bank parent to provide the necessary liquidity support to its U.S. operations. . . . the Board does not believe it would be appropriate to modify the proposed requirements to reflect an assumption that foreign banking organizations would provide such liquidity . . . . Therefore, as described further below, for purposes of the stress test used to calculate the liquidity buffer requirement for U.S. intermediate holding companies and U.S. branches and agencies, internal cash flows can only be used to offset internal cash outflows").

U.S. IHCs, including the U.S. IHC requirement are inappropriate because, to the extent that a foreign banking organization is required to form a U.S. IHC, that U.S. IHC should, consistent with well-established principles of national treatment and equality of competitive opportunity, be subject to regulation comparable to that imposed on similarly sized U.S. BHCs. Exacerbating this problem, the asset-based thresholds that trigger the imposition of enhanced prudential standards are also set too low, leading to the imposition of enhanced prudential standards on firms that do not pose meaningful systemic risks in the United States. Many legislators and regulators have advocated for an increase of applicable asset thresholds in different contexts, most recently Representative Blaine Luetkemeyer[22] and former Federal Reserve Governor Daniel K. Tarullo. All of this goes to show that regulation based on simple asset-size thresholds should be recalibrated. To the extent asset-size thresholds are increased with respect to the application of enhanced prudential standards to U.S. BHCs, they should also be increased with respect to the application of enhanced prudential standards to the U.S. operations of foreign banking organizations. Whether a foreign banking organization is subject to enhanced prudential standards should be determined based on the asset size of its U.S. IHC or U.S. subsidiaries only, regardless of the size of the foreign banking organization's parent on a consolidated basis or the amount of the foreign banking organization's U.S. branch or agency assets.

In line with the foregoing arguments, the Federal Reserve has recognized in its rulemakings related to the LCR and the NSFR that standards developed for domestic financial institutions are not necessarily the most appropriate for foreign financial institutions,[23] but it has not yet reflected this

[22] Representative Luetkemeyer sponsored the Systemic Risk Designation Improvement Act of 2016, H.R. 6392 (114th Cong., 2d Sess., 2016), which would eliminate the $50 billion asset threshold in Dodd-Frank above which banks must comply with enhanced prudential standards and instead require the imposition of enhanced prudential standards only on firms designated as systemically important by the Financial Stability Oversight Council, as well as existing G-SIBs.

[23] Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 81 Fed. Reg. 35,124 (June 1, 2016) ("The proposed rule would also not apply to the U.S. operations of foreign banking organizations or intermediate holding companies required to be formed under the Board's Regulation YY that do not otherwise meet the requirements to be a covered company (for example, as a U.S. bank holding company with more than $250 billion in total consolidated assets). The Board anticipates implementing an NSFR requirement through a future, separate rulemaking for the U.S. operations of foreign banking organizations with $50 billion or more in combined U.S. assets."); Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. (….continued)

conclusion to its regulation imposing enhanced prudential standards on foreign banking organizations.

For the foregoing reasons, SIFMA believes that the enhanced prudential standards imposed on foreign banking organizations, including the U.S. IHC requirement and enhanced prudential standards applied at the U.S. IHC level as well as the liquidity buffer and stress-testing requirements imposed on foreign banking organizations without a U.S. IHC, such as the imposition of duplicative capital stress-testing reporting requirements imposed on foreign banking organizations with large U.S. operations,[24] need to be more appropriately tailored to foreign banking organizations and are therefore inconsistent with Core Principle (f).

C. Proposed Recommendations

SIFMA continues to believe that the U.S. IHC requirement should not have been imposed on foreign banking organizations in the first place. SIFMA hopes that this discussion underscores the importance of rebalancing the enhanced prudential standards applicable to foreign banking organizations, as the following proposals would accomplish:

- The Federal Reserve should raise the asset-size thresholds that trigger the application of the U.S. IHC requirement and related enhanced prudential standards, so that fewer foreign banking organizations are subject to the U.S. IHC requirement and the application of enhanced prudential standards at the U.S. IHC level.
- For foreign banking organizations, liquidity buffer requirements and stress-testing enhanced prudential standards, including capital and liquidity stress testing requirements, should be eliminated.

(continued….)

61,440, 61,447 (Oct. 10, 2014) ("The Board is not applying the requirements of the final rule to foreign banking organizations and intermediate holding companies required to be formed under the Board's Regulation YY that are not otherwise covered companies at this time. The Board anticipates implementing an LCR-based standard through a future separate rulemaking for the U.S. operations of some or all foreign banking organizations with $50 billion or more in combined U.S. assets.").

[24] A foreign banking organization that holds $50 billion or more in U.S. assets in its U.S. subsidiaries, branches and agencies.

  - Should the liquidity stress-testing requirements not be eliminated, they should be more appropriately tailored to reflect the size of foreign banking organizations in the United States and be comparable to those imposed on similarly sized U.S. BHCs.

- In addition, and consistent with principles of international comity, and Core Principle (f) of encouraging regulation that is "efficient, effective and appropriately tailored," would be to permit substituted compliance with corresponding home-country prudential standards on a consolidated basis, provided that the home country enhanced prudential standards meet or exceed the standards of the enhanced prudential standards that are applicable to a U.S. banking organization of similar size, e.g., with regard to stress testing.

- The Federal Reserve should recalibrate the application of enhanced prudential standards to foreign banking organizations to reflect how the foreign parent within the foreign banking organization can serve as a source of strength to its U.S. operations.

  - To the extent the Federal Reserve applies the LCR rule to foreign banking organizations' U.S. IHCs, the LCR rule should be modified to account for the foreign banking organization parent's ability to provide liquidity to the U.S. IHC.

  - To the extent the Federal Reserve implements the NSFR requirement for foreign banking organizations and their U.S. IHCs, any NSFR requirement should similarly be modified to account for the foreign banking organization parent's ability to serve as a stable source of funding for the U.S. IHC.

  - Stress-testing requirements for the U.S. operations of foreign banking organizations should be tailored to avoid excessive assumptions of liquidity ring-fencing and incorporate less-punitive treatment of inter-affiliate funding flows.

- SIFMA believes that the proposed recommendations above would be the easiest and most effective means of promoting the Core Principles; however, if the Federal Reserve were not to follow these proposed recommendations, SIFMA believes that the Federal Reserve should at least:

- Modify other applicable enhanced prudential standards with respect to foreign banking organizations in a manner appropriate to address the recommendations set forth in Chapters 2, 3 and 5, including by:
  - CCAR / Stress Testing and Capital, as discussed in Chapter 2
    - Reducing the frequency of CCAR and stress-testing to a two-year cycle, which could align U.S. stress-testing with biennial E.U.-wide stress-testing, and eliminating qualitative assessments of firms' capital plans;
    - Appropriately tailoring internal TLAC requirements for foreign banking organizations and permitting U.S. IHCs to recognize internal TLAC as capital for purposes of CCAR, as internal TLAC is required to have features that would permit it to be converted into equity at the direction of the U.S. banking agencies;
    - Modifying the total leverage exposure (denominator of the SLR); and
  - Living Wills, as discussed in Chapter 5
    - Raising the asset threshold for requiring foreign banking organizations to submit resolution plans from $50 billion to an appropriate higher amount.

- Most of these changes do not require legislative amendments and could be accomplished by the Federal Reserve's amending its own regulations.
- The Federal Reserve should also engage with foreign counterparts to avoid the proliferation in other jurisdictions of overlapping and duplicative rules that provide no recognition of parent support or home-country enhanced prudential standards.

Chapter 12

DOL FIDUCIARY REGULATION

Relevant Agencies

- DOL
- SEC

Chapter 12 – DOL Fiduciary Regulation

A. Original Problem to be Remedied

The Employee Retirement Income Security Act of 1974 was enacted to protect employee benefit plan participants and their beneficiaries. Under authority granted by ERISA, the DOL promulgated its first regulation defining fiduciary investment advice with a five-part test in 1975. The test required that both the advisor and the plan mutually understand that fiduciary investment advice was being provided along with intent on the part of the plan to rely on that advice.

In 2010, the DOL released a proposal to revise that five-part test with a solution in search of a problem. The proposed rule, however, was heavily criticized for being overbroad and was ultimately withdrawn in response to strong opposition from members of both parties of Congress and the financial services sector. In 2015 the DOL reproposed the rule and it was finalized in 2016, expanding the definition of an investment advice fiduciary. The new rule more broadly defines who is a fiduciary by reason of giving investment advice, and brings into the scope of fiduciary advice, most communications with individual retirement account owners and plan participants, unless an exception is met.

The rule was originally scheduled to become applicable on April 10, 2017. Following a presidential memorandum directing the DOL to examine the rule to ensure that it does not adversely affect the ability of Americans to gain access to retirement information and financial advice, the DOL announced a 60-day extension of the applicability date of the rule to June 9, 2017. The delay provides some additional time for the industry to try to comply with the DOL's new regulations but the language in the final notice implies that the main substance of the rule is not going to be changed upon the review required by the President's memo.

SIFMA appreciates the DOL's delay in the applicability date of the rule, but strongly disagrees with its expressed intention to allow the rule to become effective within 60 days before the completion of the report mandated by the President's memorandum. The study anticipated by the President's memo could very well lead to changes to the rule itself, so it is unreasonable for the DOL to implement any part of the rule without the full study being completed. This path will be chaotic for retirement investors and for the industry.

B. Need for Rebalancing

The final rule is extremely complex and will negatively impact customer choice, access to investor education and may increase the cost of retirement products and services for millions of investors.

Today, in the retail market, investors generally have two choices on who they can work with to provide them investment advice. Investors can choose to work with a fiduciary investment advisor who provides investment advice and who typically is paid an asset-based investment advisory fee, or, investors can work with an investment professional who provides them with investment education and market information and who typically gets paid through transaction-based commissions. The vast majority of investors, particularly small investors, choose to work with commissioned investment professionals.

The final rule creates a complicated new structure for investment advice through the best interest contract prohibited transaction exemption which includes an unprecedented and burdensome list of operational and compensation-related conditions that firms and advisors must follow. The exemptions rely on private plaintiffs to enforce the rules, which significantly increases the likelihood of litigation. This will likely lead to even further increases to the costs of products and services to retirement investors to reflect the risk of, and expense associated with, defending potentially disruptive class actions that have become a hallmark in the 401(k) plan arena.

In addition, financial services and insurance are among the most comprehensively regulated industries in the United States. These regulations are rigorously enforced by the SEC and other government agencies, fifty state regulators and self-regulatory organizations such as the FINRA. The DOL's fiduciary rule fails to account for the many existing laws and regulations already governing the financial advice and services.

C. Proposed Recommendations

For over eight years and counting, SIFMA has strongly supported enhancing investor protections by establishing a heightened and more stringent broker-dealer best interest standard.

Specifically, SIFMA recommends:

- DOL delay of the rule's implementation at least until a full study is completed as anticipated by the Presidential memorandum of February 3, 2017.
- SEC action to establish a uniform fiduciary standard for broker-dealers and investment advisers applicable when they are providing personalized investment advice about securities to retail customers.
    - Apply the best interest standard across *all* securities recommendations made to retail customers in *all* broker-dealer accounts, not just to IRA accounts.
    - Fit the best interest standard within the existing and long-standing securities regulatory regime for broker-dealers.
    - Require rigorous examination, oversight, and enforcement by the SEC, FINRA and state securities regulators.

GLOSSARY

Glossary

Term / Acronym	Definition
ASF	Available Stable Funding
Banking organization	A bank holding company, bank, savings association or savings and loan holding company subject to the U.S. Basel III capital rules, or a U.S. bank holding company or intermediate holding company of a foreign banking organization
Basel I	Basel Capital Accord
Basel III	The Basel III Framework for Capital Adequacy
Basel Committee	Basel Committee on Banking Supervision
BHC	Bank Holding Company
BHC Act	Bank Holding Company Act of 1956
CAMELS	Capital, Assets, Management, Earnings, Liquidity and Sensitivity
CCAR	Comprehensive Capital Analysis and Review
CCP	Central Counterparties
CEM	Current Exposure Method
CET 1	Common Equity Tier 1, a permanent, loss-absorbing form of bank capital that includes common equity and related surplus, retained earnings, and accumulated other comprehensive income
CFPB	Consumer Financial Protection Bureau
CFTC	Commodity Futures Trading Commission
CLAR	Comprehensive Liquidity Assessment and Review
CLO	Collateralized Loan Obligations
Congressional Review Act	Legislation that allows Congress to issue a joint resolution to disapprove federal agency regulatory rules
Core Principles	Core Principles for Regulating the United States Financial System, set forth in Presidential Executive Order from February 3, 2017
DFAST	Dodd-Frank Act Stress Test

Term / Acronym	Definition
Dodd-Frank Act	The Dodd-Frank Wall Street and Consumer Protection Act of 2010
DOL	U.S. Department of Labor
ERISA	The Employee Retirement Income Security Act of 1974
EU	The European Union
Exchange Act	The Securities Exchange Act of 1934
Fannie Mae	See FNMA
FAQ	Frequently Asked Questions
FDIA	The Federal Deposit Insurance Act of 1950
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	The Board of Governors of the Federal Reserve System
Federal Reserve Act	The Federal Reserve Act of 1913
FFIEC	Federal Financial Institutions Examination Council
FHC	Financial Holding Company
FHFA	Federal Housing Finance Agency
FHLMC	Federal Home Loan Mortgage Corporation, commonly known as Freddie Mac
FNMA	Federal National Mortgage Association, commonly known as Fannie Mae
FINRA	Financial Industry Regulatory Authority
Freddie Mac	See FHLMC
FSOC	Financial Stability Oversight Council
G20	An international forum for the governments and central bank governors from 20 major economies
G-SIB	Global Systemically Important Bank
G-SIB Surcharge	Additional risk-based capital surcharge that applies to Basel III standard on U.S. global systemically important bank relying on short-term wholesale funding
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office

Term / Acronym	Definition
GDP	Gross Domestic Product
GFMA	The Global Financial Markets Association
Gramm-Leach Bliley Act	The Financial Services Modernization Act of 1999
GSE	Government-Sponsored Entity
Guide 3	SEC industry guide that outlines statistics required to be included in certain BHC disclosure documents
HQLA	High-Quality Liquid Assets
HUD	U.S. Department of Housing and Urban Development
IDI	Insured Depository Institution
IHC	Intermediate Holding Company
IIF	The Institute of International Finance
IPO	Initial Public Offering
IRA	Individual Retirement Account
ISDA	The International Swaps and Derivatives Association
ISDA 2015 Universal Resolution Stay Protocol	International protocol developed by ISDA that provides for the contractual recognition of statutory stays under special resolution regimes and contractual limitations on early termination rights based on cross-defaults in QFCs
JOBS Act	Jumpstart Our Business Startups Act
LCR	Liquidity Coverage Ratio
Level 2B	Category of assets such as lower rated corporate bonds that, under certain circumstances, can be counted as HQLAs
NASDAQ	The Nasdaq Stock Market
NCUA	National Credit Union Administration
Nonbank SIFI	Nonbank Systemically Important Financial Institution
NSFR	Net Stable Funding Ratio
OCC	Office of the Comptroller of the Currency

Term / Acronym	Definition
OLA	Orderly Liquidation Authority
OTC	Over-the-Counter
QFC	Qualified Financial Contracts
QIB	Qualified Institutional Buyer
QM	Qualified Mortgage
RCEN	Resolution Capital Execution Need
Reg AB II	The SEC's Regulation AB II
Reg SHO	The SEC's Short Sale Regulation
Regulation Y	Federal Reserve rule that governs corporate practices of BHCs and certain state-member banks
Regulation YY	Federal Reserve enhanced prudential standards rule that implements provisions from Section 165 and 165 of the Dodd-Frank Act
RENTD	Reasonably Expected Near Term Demand
RESPA	The Real Estate Settlement Procedures Act
RLAP	Resolution Liquidity Adequacy and Positioning
RLEN	Resolution Liquidity Execution Need
RSF	Required Stable Funding
RWA	Risk Weighted Assets
S.828	115th Congress Senate bill to amend the Federal Deposit Insurance Act to require the appropriate Federal banking agencies to treat certain municipal obligations as Level 2B liquid assets, and for other purposes
SA-CCR	The Basel Committee's Standardised Approach for Measuring Counterparty Credit Risk
Sarbanes-Oxley Act	The Sarbanes-Oxley Act of 2002
SCCL	Single-Counterparty Credit Limits
SEC	Securities and Exchange Commission
Section 23A	Federal Reserve Act section that regulates transactions between an IDI and its non-depository affiliates
Securities Act	The Securities Act of 1933

Term / Acronym	Definition
SEF	Swap Execution Facility
SLR	Supplementary Leverage Ratio
SOX 404	Sarbanes-Oxley Act section that requires public companies to establish internal controls and procedures for financial reporting
SPOE	Single Point of Entry
SSFA	Simplified Supervisory Formula Approach
Super 23A	Provision of the Volcker Rule that limits transactions between entities involved in managing or advising covered funds
Tier 1 capital	A measurement of core capital that consists primarily of common equity and retained earnings, with the possible addition of loss absorbing securities such as contingent convertible bonds and non-redeemable, non-cumulative preferred stock
Tier 1 leverage ratio	A ratio between a firm's core capital (see Tier 1 capital definition) and its total assets
TILA	The Truth-in-Lending Act
Title VII	Title VII of the Dodd-Frank Act
TLAC	Total Loss Absorbing Capacity
Total leverage exposure	Denominator of the Supplementary Leverage Ratio, including a combination of on and off-balance sheet exposures as defined by Basel III
TRID	TILA-RESPA Integrated Disclosures Rule
U.S. banking agencies	Board of Governors of the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC)
U.S. Basel III capital requirements	In 2013, the Federal Reserve finalized implementation Basel III capital rules to ensures that banks had sufficient capital to continue lending to creditworthy households and business in times of stress
VaR	Value at Risk

Term / Acronym	Definition
Volcker Rule	Section 619 of the Dodd-Frank Act, codified in Section 13 of the BHC Act
WKSI	Well-Known Seasoned Issuer

Appendices

—Appendix A. Annotated Bibliography of Past Comments, Studies and Reports

—Appendix B. Sources for Figures

Appendix A – Annotated Bibliography of Past Comments, Studies and Reports

A. Regulatory Architecture and Good Governance

Primary Sources

Administrative Procedure Act of 1946 (link).

The Administrative Procedure Act of 1946 is the principal federal statute establishing the legal standards for how administrative agencies adopt and enforce rules and regulations and issue interpretative guidance.

Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1878, Public Law 95-630 (link).

Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1878 created the FFIEC, an interagency body with a mandate to prescribe uniform standards for federal examinations of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions.

Section 112(a)(2) of the Dodd-Frank Act (July 21, 2010) (link).

Section 112(a)(2) of the Dodd-Frank Act sets forth the duties of the newly-created FSOC, which include, among others:

- the duty to make recommendations to enhance the integrity, efficiency, competitiveness and stability of the U.S. financial markets
- the duty to coordinate among member agencies on domestic financial services policy development, rulemaking, examinations, reporting requirements and enforcement actions
- the duty to recommend to the member agencies general supervisory priorities and principles.

Executive Order 12866 (Sept. 30, 1993) (link).

Executive Order 12866 is an executive order passed by President Clinton with the purpose, among others, to restore the integrity and legitimacy of regulatory oversight and to make the process more accessible and open to the public. Among other things, the Executive Order requires executive agencies to perform a cost-benefit analysis of proposed new rules, taking into account both quantitative and qualitative measures and considering available alternatives. The Executive Order requires that agencies:

- avoid regulations that are inconsistent, incompatible or duplicative
- tailor regulations to impose the least burden on society
- take into account the costs of cumulative regulations
- assure that regulations are consistent with the President's priorities

Executive Order 12631 (Mar. 18, 1988) (link).

Executive Order 12631 created a Working Group on Financial Markets composed of the heads of Treasury, the Federal Reserve, the SEC and the CFTC with the goal of enhancing the integrity, efficiency, orderliness and competitiveness of the U.S. financial markets and maintaining investor confidence. The Working Group was mandated to consult with market participants and report to the President on its views as to any recommended legislative changes.

Secondary Sources

Michael Barr, Howell E. Jackson and Margaret E. Tahyar, FINANCIAL REGULATION: LAW AND POLICY (2016).

This textbook provides a comprehensive overview of U.S. regulation of a wide range of financial activities, as well as regulatory techniques including supervision, enforcement and rule-making. Chapter 1.4, "The Regulatory Perimeter," provides a conceptual taxonomy for understanding overlapping and conflicting regulatory authority.

Davis Polk & Wardwell LLP, *Six-Year Anniversary Report on Dodd-Frank Rulemaking Progress* (July 19, 2016) (link).

The Davis Polk Report states that as of July 19, 2016, of the 390 total rulemaking requirements under the Dodd-Frank Act, 274 (70.3%) had been met with finalized rules and rules had been proposed that would meet 36 (9.2%) more. Rules had not yet been proposed to meet 80 (20.5%) rulemaking requirements.

GAO, *Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness* (Feb. 2016) (link).

The GAO report reviews the fragmented and overlapping structure of U.S. financial regulation. The report recommends that Congress give FSOC the tools needed to coordinate effectively among financial regulatory agencies.

Group of 30, *The Structure of Financial Supervision* (Oct. 2008) (link).

This report provides an overview of approaches to financial supervision across different countries, assessing design and implementation issues. The report highlights the exceptional nature of the U.S. system due to its complexity and overlapping regulatory authorities.

Jerome H. Powell, *Speech at the Global Finance Forum* (Apr. 20, 2017) (link).

In this speech, Powell looks back at the regulations put in place following the financial crisis and asks what changes have worked and where adjustments should be made.

Richard Neiman and Mark Olson, *Modernizing Our Regulatory Structure* (Apr. 14, 2014) (link).

The authors, a former New York Superintendent of Banks and former Governor of the Federal Reserve, urge Congress to act to rationalize and modernize the U.S. regulatory architecture. Among other things, they urge federal banking regulators to create a consolidated examination force.

Elizabeth F. Brown, Prior Proposals to Consolidate Federal Financial Regulators (Apr. 20, 2015) (link).

This paper provides an excellent review of past proposals for reform of the federal financial regulatory architecture.

Bipartisan Policy Center, *Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture* (Apr. 2014) (link).

This report by the Regulatory Architecture Task Force of the Bipartisan Policy Center presents a road map for how to achieve a more rational and effective financial regulatory architecture in accordance with guiding principles such as regulatory coordination and efficiency, transparency and accountability of the regulatory structure, and improvement of the quality of regulation.

Volcker Alliance, *Reshaping the Financial Regulatory System* (2015) (link).

This report describes the U.S. financial regulatory architecture as fragmented, outdated and ineffective and makes recommendations about how to improve it. The report argues that since the main focus of the Dodd-Frank Act was to strengthen and expand the scope of regulation, rather than to rationalize the regulatory framework, many of the financial system's structural deficiencies remain unaddressed.

Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Mar. 31, 2008) (link).

Treasury's Blueprint presented a series of recommendations for reform of the U.S. regulatory structure in an effort to improve the competitiveness of the U.S. financial markets in the global marketplace. Among other things, the Blueprint recommended eliminating some of the duplication in the U.S. regulatory system, improving regulatory coordination and modernizing the U.S. regulatory architecture.

Edward Herlihy and Richard Kim, *It's Time for the Pendulum to Swing Back* (Feb. 17, 2017) (link).

The authors argue that over the past several years, financial regulators have taken away control from boards of directors and management of banks by using corporate governance as a supervisory tool.

Charles K. Whitehead, *Reframing Financial Regulation* (Feb. 2010) (link).

In this law review article, Charles Whitehead, a law professor at Cornell Law School, argues that U.S. financial regulatory architecture should shift its historical focus from business categories to issues and risks that arise across categories or functions.

House Committee on Oversight and Government Reform, *Federal Deposit Insurance Corporation's Involvement in "Operation Choke Point"* (Dec. 8, 2014) (link).

This Staff Report reports on a Congressional investigation into a federal initiative forcing banks to terminate relationships with businesses that federal regulators deemed to be high-risk. The Report found that senior FDIC policymakers opposed to payday lending and other legitimate businesses attempted to use the FDIC's supervisory authority to prohibit the practice. It concluded that

Operation Choke Point violated the fundamental principles of the rule of law and accountable, transparent government.

Ernest T. Patrikis, *Supervision and Enforcement*, in Regulation of Foreign Banks & Affiliates in the United States (Randall D. Guynn ed., 9th ed. 2016).
In this chapter, Ernest Patrikis, partner at the law firm White & Case, discusses supervision and enforcement by U.S. regulators relating to the banking and nonbanking activities of foreign banking organizations in the United States.

Robert H. Jackson, *The Federal Prosecutor* (Apr. 1, 1940).
In this speech, Robert H. Jackson, then Attorney General, discusses abuse of prosecutorial discretion versus the rule of law and good government.

David Skeel, *A Nation Adrift from the Rule of Law*, Wall Street Journal (Aug. 21, 2012).
This article discusses the developments in the rule of law, using examples of the Dodd-Frank Act's liquidation requirement and the 2008 Troubled Asset Relief Program legislation.

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B. Stress Testing and Capital Requirements

1. CCAR and Stress Testing Requirements

Primary Sources

Federal Reserve, *SCAP Guidance* (Nov. 17, 2010) (link).
The Federal Reserve's CCAR program originated in 2010 in the form of these guidelines issued to the 19 BHCs then subject to its Supervisory Capital Assessment Program.

Federal Reserve, *Capital Plan Rule* (Dec. 1, 2011) (link).
The Federal Reserve codified CCAR when it adopted this final rule, which amended its Regulation Y to require BHCs with total consolidated assets of $50 billion or more to submit annual capital plans to the Federal Reserve.

Federal Reserve, *Stress Test Rule* (Oct. 12, 2012) (link).
Section 165(i) of the Dodd-Frank Act required the Federal Reserve to adopt regulations on the annual supervisory stress testing requirement (for BHCs with $50 billion or more in total consolidated assets and non-bank SIFIs designated by the FSOC) and semi-annual company-run stress testing requirement (for financial companies with $10 billion or more in total consolidated assets). The Federal Reserve adopted those regulations in this final rule.

Federal Reserve, *Amendments to Capital Plan and Stress Test Rules* (Oct. 27, 2014) (link).

The Federal Reserve adopted this final rule to amend its capital planning and stress testing rules, including by shifting the due date for capital plan and stress test results submissions from January to April beginning in the 2016 cycle.

Federal Reserve, *Amendments to Capital Plan and Stress Test Rules* (Feb. 3, 2017) (link).

The Federal Reserve adopted this final rule to amend its capital planning and stress testing rules, including by exempting "large and noncomplex" CCAR firms (i.e., non-G-SIB bank holding companies with total consolidated assets between $50 billion and $250 billion and total nonbank assets of less than $75 billion) from qualitative review in the CCAR process.

Federal Reserve, *2017 CCAR and Stress Test Scenarios* (Feb. 10, 2017) (link).

The Federal Reserve releases the baseline, adverse and severely adverse scenarios for the annual stress testing cycle each year in late January or early February, with CCAR firms' capital plans due in early April. The 2017 severely adverse scenario includes a 10% U.S. unemployment rate and severe stress in corporate loan markets and commercial real estate markets.

Federal Reserve, *2016 CCAR Results* (June 2016) (link); and
Federal Reserve, *Dodd-Frank Act Stress Test 2016: Supervisory Stress Test Methodology and Results* (June 2016) (link).

The Federal Reserve releases the results of its annual stress testing cycle each year in late June or early July. These documents outline the results for the 33 bank holding companies subject to CCAR in the 2016 stress testing cycle. No banks failed on quantitative grounds in 2016, but the Federal Reserve objected to two banks' capital plans qualitative grounds.

Secondary Sources

GAO, *Federal Reserve: Additional Actions Could Help Ensure the Achievement of Stress Test Goals* (Nov. 2016) (link).

The GAO made recommendations to improve the effectiveness of the Federal Reserve's stress testing, including various recommendations related to increasing the transparency of the programs. According to a leaked memo from Rep. Hensarling, the Financial CHOICE Act 2.0 would codify these recommendations.

The Clearing House, *Comparison between United States and European Union Stress Tests* (May 2016) (link).

This research note compares the European Banking Authority's 2016 stress testing scenarios with the Federal Reserve's 2016 CCAR scenarios. Positive attributes of the EU stress testing regime highlighted in this paper include imposition of a moderate recession scenario and reliance on banks' own internal models to estimate losses and revenues.

The Clearing House, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test* (Jan. 2017) (link).

In this research note, The Clearing House derives the capital requirements implicit in the CCAR stress test for various asset classes and finds that for certain asset classes, including loans to small businesses and residential mortgage loans, those requirements are significantly higher than (1) the applicable requirements derived from banks' internal models and (2) the applicable requirements imposed by the Basel III advanced approaches rules.

Davis Polk & Wardwell LLP, *Supplementary Leverage Ratio* (Sept. 12, 2016) (link).

This client memorandum summarizes the September 2014 final rule.

2. Capital Requirements

Primary Sources

U.S. Banking Agencies, *U.S. Basel III Final Rule* (Oct. 11, 2013) (link).

The U.S. Banking Agencies' Basel III final rule represented the most complete overhaul of U.S. bank capital standards since the U.S. adoption of Basel I in 1989. It includes rules on the standardized and advanced approaches to calculating risk-based capital and on the SLR for advanced approaches banking organizations.

U.S. Banking Agencies, *Enhanced Supplementary Leverage Ratio Final Rule* (May 1, 2014) (link).

This final rule implemented the enhanced SLR" for U.S. G-SIBs and their insured depository institution subsidiaries—a key example of gold-plating by the U.S. Banking Agencies. The Basel Committee's international SLR rule includes no such buffer for G-SIBs. The enhanced SLR is scheduled to go into effect on January 1, 2018.

U.S. Banking Agencies, *Revisions to Definition of "Total Leverage Exposure"* (Sept. 26, 2014) (link).

The U.S. Banking Agencies revised the definition of "Total Leverage Exposure," the denominator of the SLR, that had been included in their Basel III final rule. The U.S. Banking Agencies did not exclude cash, central bank deposits or sovereign securities from Total Leverage Exposure, despite comments from the sector requesting such an exclusion.

Federal Reserve, *G-SIB Surcharge Final Rule* (Aug. 14, 2015) (link).

This final rule implemented the G-SIB surcharge. The Federal Reserve gold plated the Basel Committee's international standard by adopting Method 2 that results in significantly higher surcharges for the U.S. G-SIBs.

Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010; revised June 2011) (link).

This international Basel III framework served as the basis for the U.S. Banking Agencies' Basel III final rule

Basel Committee, *Basel III Leverage Ratio Framework and Disclosure Requirements* (Jan. 2014) (link).

This international Basel III framework served as the basis for the U.S. Banking Agencies' SLR final rule.

Basel Committee, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (July 2013) (link).

This international Basel III framework served as the basis for the U.S. Banking Agencies' G-SIB surcharge final rule. Notably, the international framework does not provide for a Method 2 surcharge score.

Basel Committee, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III regulations—United States of America* (Dec. 2014) (link).

The Basel Committee reports on the domestic adoption of the Basel III framework by its individual members, assessing their progress adopting regulations that are consistent with the internationally agreed standards. This report on the U.S. Banking Agencies' U.S. Basel III final rule provides a helpful overview of where the U.S. Basel III final rule diverges from the international framework.

Secondary Sources

Oliver Wyman, *Interaction, Coherence, and Overall Calibration of Post Crisis Basel Reforms* (Aug. 9, 2016) (link).

The consulting firm Oliver Wyman conducted a quantitative analysis of the cumulative long-term impacts of the Basel capital (and liquidity) reforms.

SIFMA, American Bankers Association and Financial Services Roundtable, *Comment Letter on Proposals to Comprehensively Revise the Regulatory Capital Framework for U.S. Banking Organizations* (Oct. 22, 2012) (link).

SIFMA and other trade associations commented on the U.S. Banking Agencies' Basel III proposed rule.

SIFMA, American Bankers Association and Financial Services Roundtable, *Comment Letter on Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions* (Oct. 21, 2013) (link).

SIFMA and other trade associations commented on the U.S. Banking Agencies' proposed rule on the enhanced SLR for the U.S. G-SIBs.

Òscar Jordà et al., *Bank Capital Redux* (Mar. 2017) (link).

This working paper argues that, based on an empirical analysis of the liability side of banks' balance sheets, "higher capital requirements are unlikely to prevent a financial crisis."

GAO, *Federal Reserve: Additional Actions Could Help Ensure the Achievement of Stress Test Goals* (Nov. 2016) (link).

The GAO made recommendations to improve the effectiveness of the Federal Reserve's stress testing, including various recommendations related to increasing the transparency of the programs. According to a leaked memo from Rep. Hensarling, the Financial CHOICE Act 2.0 would codify these recommendations.

The Clearing House, *Comparison between United States and European Union Stress Tests* (May 2016) (link).

This research note compares the European Banking Authority's 2016 stress testing scenarios with the Federal Reserve's 2016 CCAR scenarios. Positive attributes of the EU stress testing regime highlighted in this paper include imposition of a moderate recession scenario and reliance on banks' own internal models to estimate losses and revenues.

The Clearing House, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test* (Jan. 2017) (link).

In this research note, The Clearing House derives the capital requirements implicit in the CCAR stress test for various asset classes and finds that for certain asset classes, including loans to small businesses and residential mortgage loans, those requirements are significantly higher than the applicable requirements derived from banks' internal models and the applicable requirements imposed by the Basel III advanced approaches rules.

Mark J. Welshimer and Andrew R. Gladin, *U.S. Capital and Liquidity Regulation of Foreign Banking Organizations*, in Regulation of Foreign Banks & Affiliates in the United States (Randall D. Guynn ed., 9th ed. 2016).

In this chapter, Mark J. Welshimer and Andrew R. Gladin, partners at the law firm Sullivan & Cromwell, provide a high level description of U.S. capital and liquidity regulation, as well as foreign banking organization capital adequacy and liquidity regulation.

Michael Barr, Howell E. Jackson and Margaret E. Tahyar, *Financial Regulation: Law and Policy* (2016).

Chapter 2.5, "Capital Regulation: An Introduction," Chapter 2.6, "Capital Regulation: Pre-Financial Crisis to Basel II," and Chapter 2.7, "Capital Regulation: Basel III and Beyond" of this casebook, "Foreign Banks in the United State and U.S. Banks Abroad," all provide the basics of capital regulation and its history.

Davis Polk & Wardwell LLP, *Visual Memorandum on U.S. Basel III Final Rule* (Apr. 30, 2015) (link).

This visual memorandum summarizes the July 2013 final rules.

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C. Liquidity and Funding Requirements

Primary Sources

U.S. Banking Agencies, *Liquidity Coverage Ratio Final Rule* (Oct. 10, 2014) (link).
The final rule implementing the LCR in the United States.

Basel Committee, *Principles for Sound Liquidity Risk Management and Supervision* (Sept. 2008) (link).
The key principles on liquidity that served as the basis for the international LCR framework.

Basel Committee, *Basel III: A Global Regulatory Framework* (Dec. 2010; revised June 2011) (link).
The international Basel III framework that served as the basis for the U.S. Banking Agencies' Basel III risk-based capital and the LCR final rules. It was further revised in January 2013.

Basel Committee, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (Jan. 2013) (link).
The revised international LCR framework that served as the basis for the U.S. Banking Agencies' LCR final rule.

Basel Committee, *Basel III: Net Stable Funding Ratio* (Oct. 2014) (link).
The final version of the NSFR framework that requires banks to maintain a stable funding profile.

Federal Reserve and FDIC, *Guidance for Domestic Companies' 2017 §165(d) Resolution Plans* (Apr. 13, 2016) (link).
Agency guidance that requires the largest banking organizations to develop new modeling for resolution liquidity needs.

U.S. Banking Agencies, *Net Stable Funding Ratio Proposed Rule* (June 1, 2016) (link).
The proposed rule to implement the NSFR in the United States.

Federal Reserve, *Liquidity Coverage Ratio; Public Disclosure Requirements* (Dec. 19, 2016) (link).
The final rule implementing public disclosure requirements for BHCs subject to the LCR.

Secondary Sources

Oliver Wyman, *Interaction, Coherence, and Overall Calibration of Post-Crisis Basel Reforms* (Aug. 9, 2016) (link).
Primarily analyzes the long-term effects of the Basel Committee's post-crisis capital and liquidity requirements.

Douglas W. Diamond and Philip H. Dybvig, *Bank Runs, Deposit Insurance and Liquidity* (1983) (link).

A seminal article on the collective action problem that gives all depositors in a bank an incentive to run if they believe other depositors will run.

Adrian Blundell-Wignall and Paul Atkinson, *Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity* (2010) (link).

Examines how Basel III proposals address insolvency resulting from contagion and counterparty risk among others. "Maturity transformation is a key function of the banking system, and notwithstanding the crisis banks should not be treated as being naïve in running their own businesses. The cause of the crisis was a solvency problem, after which uncertainty rose as to banks' ability to pay which, in turn, led to a buyers strike affecting short-dated funding."

SIFMA, et al., *Comment Letter on Net Stable Funding Ratio Proposed Rule* (Aug. 5, 2016) (link).

The 72-page comment letter by SIFMA and other trade associations on the proposed Net Stable Funding Ratio arguing that implementation is unnecessary because key reforms already enacted, including the Liquidity Coverage Ratio, will ensure that banking organizations maintain stable funding and liquidity profiles.

Davis Polk & Wardwell LLP, *U.S. Basel III Liquidity Coverage Ratio Final Rule* (Sept. 23, 2014) (link).

The Davis Polk visual memo on the final LCR rule.

Davis Polk & Wardwell LLP, *Federal Reserve's Final Rule on Total Loss-Absorbing Capacity and Eligible Long-Term Debt* (Jan. 11, 2017) (link).

The Davis Polk visual memo on the final TLAC rule.

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D. The Volcker Rule

Primary Sources

Section 619 of the Dodd-Frank Act (July 21, 2010) (link).

Section 619 of the Dodd-Frank Act is the statutory text of the Volcker Rule, which spans just over 11 pages in length. Section 619 was included at the eleventh hour in the Senate version of the Dodd-Frank Act.

U.S. Banking Agencies and SEC, *Volcker Regulations* (Jan. 31, 2014) (link).

The final Volcker Regulations took three and a half years for the four of five agencies to agree on. They are nearly 1,000 pages and contain 2,826 footnotes. Davis Polk visual memoranda explain the proprietary trading provisions (link) and the covered fund provisions (link).

CFTC, *Volcker Regulations* (Jan. 31, 2014) (link).

The CFTC's version of the final Volcker Regulations was published separately from the other four agencies and contains an additional 7 footnotes, totaling 2,833 footnotes.

U.S. Banking Agencies, CFTC and SEC, *Frequently Asked Questions* (last updated Mar. 4, 2016) (link).

The five agencies, via an inter-agency working group, have issued 21 Frequently Asked Questions related to the Volcker Regulations. The agencies have not issued an FAQ in more than one year.

Federal Reserve, *Order Approving Extension of Conformance Period* (Dec. 10, 2013) (link).

The Federal Reserve issued an order that extended until July 21, 2015 the conformance period of the Volcker Regulations for all banking entities.

Federal Reserve, *Order Approving Extension of Conformance Period* (Jul. 7, 2016) (link).

The Federal Reserve issued an order that extended until July 21, 2017 the conformance period of the Volcker Regulations for legacy covered fund investments and relationships made by banking entities before December 31, 2013.

U.S. Banking Agencies and SEC, *Trust Preferred Securities Interim Final Rule* (Jan. 31, 2014) (link).

Four of the five agencies released an interim final rule that generally permits banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities (TruPS Collateralized Debt Obligations). Davis Polk's memorandum, *Who Knew that CLOs were Hedge Funds?* (Feb. 10, 2014) (link), explains the treatment of collateral loan obligations under the Volcker Regulations.

FSOC, *Recommendations for Prohibitions on Proprietary Trading & Covered Funds* (Jan. 2011) (link).

The 2011 FSOC study, which was required to be created under the Volcker Rule statute, set forth a general framework to guide the five agencies in writing the Volcker Regulations and gave the agencies a great deal of discretion rather than prescribing specific standards for the Volcker Regulations. Davis Polk's memoranda describes the proprietary trading provisions (link) and the covered funds provisions (link).

Federal Reserve, *Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds* (Dec. 9, 2016) (link).

The Federal Reserve issued guidance regarding the procedures that a banking entity must follow in order to receive an extension from the general legacy covered funds conformance period of July 21, 2017 for a period of up to five years.

Secondary Sources

Daniel K. Tarullo, *Departing Thoughts* (Apr. 4, 2017) (link).

In his final speech as a governor of the Federal Reserve, Tarullo (the *de facto* Federal Reserve Vice Chair of Bank Supervision) described his reasons for why the Volcker Rule is "too complicated" and why it "may have a deleterious effect on market making, particularly for some less liquid issues."

Jack Bao, Maureen O'Hara and Alex Zhou, *The Volcker Rule and Market-Making in Times of Stress* (Sept. 2016) (link).

The Federal Reserve's staff paper on the implementation of the Volcker Rule and its impact on bond market liquidity, particularly in times of market stress, studies the market liquidity of downgraded corporate bonds before and after the implementation of the Volcker Rule and finds that the rule may have "serious consequences for corporate bond market functioning in stress times." The paper ultimately concludes that "the Volcker Rule has a deleterious effect on corporate bond liquidity and dealers subject to the Rule become less willing to provide liquidity during stress times."

Steven Mnuchin, *Senate Finance Committee Testimony* (Jan. 19, 2017) and *Related Questions for the Record* (Jan. 24, 2017) (link).

Mnuchin, during his nomination Senate testimony, called the Volcker Rule too complex: "The number one problem with the Volcker Rule is it's too complicated and people don't know how to interpret it. So we're going to look at what to do with it, as we are with all of Dodd-Frank." Mnuchin, as his testimony demonstrates, is in favor of revising the definition of proprietary trading in a way that does not impair liquidity.

Jerome H. Powell, *Low Interest Rates and the Financial System* (Jan. 7, 2017) (link).

Powell criticized the Volcker Regulations in a speech, in which he stated: "What the current law and rule do is effectively force you to look into the mind and heart of every trader or every trade to see what intent is. Is it proprietary trading or something else? If this is the test you set for yourself, you are going to wind up with tremendous expense and burden."

Ronald Kruszewski, *House Financial Services Subcommittee Testimony on the impact of the Volcker Rule* (Mar. 29, 2017) (link).

Ronald Kruszewski, the Chair and CEO of Stifel, testified before Congress on behalf of SIFMA that the Volcker Rule should be repealed because it provides "little benefit regarding its purpose when enacted which was to reduce systemic financial risk by banning proprietary trading" and, in the absence of repeal, that the Rule should be amended in line with the Core Principles.

David Blass, *House Financial Services Subcommittee Testimony on the impact of the Volcker Rule* (Mar. 29, 2017) (link).

David Blass, the General Counsel of the Investment Company Institute, testified before Congress that the Volcker Rule should (among others) be amended to provide a complete exemption for registered funds and to resolve the competitive inequalities placed on U.S. firms (and their affiliates) that rely on the non-U.S. public fund exclusion.

Thomas Quaadman, *House Financial Services Subcommittee Testimony on the impact of the Volcker Rule* (Mar. 29, 2017) (link).

Thomas Quaadman, the Executive Vice President for the Center for Capital Markets Competitiveness of the Chamber of Commerce testified before Congress that the Volcker Rule should be repealed or amended because (among others) of the "foreseeable negative consequences of the rule, such as restricting market-making and underwriting activities, which in turn impact the ability of businesses to obtain the financing needed for short-term operations and long-term growth."

Charles Whitehead, *House Financial Services Subcommittee Testimony on the impact of the Volcker Rule* (Mar. 29, 2017) (link).

Charles Whitehead, a Cornell law professor, testified before Congress that the Volcker Rule should be repealed because "the problems leading up to the financial crisis did not arise from short-term proprietary trading, and so—particularly in light of the Volcker Rule's substantial costs—it is unclear why banning that activity from banking entities is necessary" and that "doing so inadvertently sweeps up a number of legitimate trading businesses and, as a result, potentially raises the cost of new capital."

National Venture Capital Association, *Letter to the House Financial Services Subcommittee* (Mar. 29, 2017) (link).

The National Venture Capital Association letter urges Congress to explore the impact of the Volcker Rule on capital formation for startups, particularly in the Midwest and areas of the country that are not typically associated with startup activity. The letter asserts that the current Volcker Rule "has significantly hurt venture capital fund formation" and drives out investment in many venture capital funds that are not big enough to receive investment from major institutional capital pools.

Camille L. Orme and Whitney A. Chatterjee, *The Volcker Rule*, in Regulation of Foreign Banks & Affiliates in the United States (Randall D. Guynn ed., 9th ed. 2016).

In this chapter, Camille L. Orme and Whitney A. Chatterjee, partners at the law firm Sullivan & Cromwell, provide a high level description of the Volcker Rule and its impact on foreign banks and their U.S. affiliates.

Jussi Keppo and Josepf Korte, *Risk Targeting and Policy Illusions – Evidence from the Announcement of the Volcker Rule* (June 2016) (link).

This article concluded that overall bank risk levels did not decline after announcement of the Volcker Rule.

Sohhyun Chung et al., *The Impact of Volcker Rule on Bank Profits and Default Probabilities* (June 2016) (link).

This paper found that the Volcker Rule raised the default probabilities of 34 U.S. banks by decreasing the size of the liquid trading book and increasing the illiquid banking book.

John C. Coates, *The Volcker Rule as Structural Law: Implications for Cost-Benefit Analysis and Administrative Law* (link).

This paper concludes that the Volcker Rule could not be the subject of reliable, precise, quantified cost-benefit analysis, given that it would require regulators to anticipate, in advance of data, private market behavior in response to novel activity constraints.

Jai R. Massari and Gabriel D. Rosenberg, *The Volcker Rule's Risk Backstop Provisions* (2015) (link).

This law review article on the backstop prohibitions of the Volcker Regulations ultimately suggest that the agencies avoid the temptation of the backstop approach when seeking to identify systemically risky firms or activities, and provides suggestions for minimizing these adverse outcomes.

Jai R. Massari, *Foreign Bank Cross-Border Trading under the Volcker Rule* (2015) (link).

This law review article on the exemption for non-U.S. banks that engage in trading activities outside of the United States (TOTUS) suggests modifications to the TOTUS exemption for the agencies to consider to better align the exemption with the stated policy objectives as well as existing regulatory requirements and market structure that govern securities transactions.

Senator Mike Crapo, *Letter to U.S. Banking Agencies, CFTC and SEC* (Dec. 18, 2013) (link).

Senator Crapo (R-Idaho), the current Senate Banking Committee Chair, sent a letter to the five agencies shortly after the Volcker Regulations were released, in which he expressed concern with the "unintended consequences of the nearly 1,000 page final rule and its preamble."

House and Senate Volcker Colloquies (Jun. 29-30, Jul. 14-15, 2010) (link).

These colloquies from the House and Senate floor illustrate the debate regarding the Volcker Rule just before Section 619 was included in the Dodd-Frank Act. Colloquies include statements from Senators Brown, Hagan, Merkley, Levin, Boxer, Dodd and Bayh and Representatives Himes and Frank. Some of these colloquies said that Congress did not intend to prohibit certain activities that the text of the Volcker Rule statute appears to prohibit.

U.S. Chamber of Commerce's Center for Capital Markets Competitiveness, *The Economic Consequences of the Volcker Rule* (Summer 2012) (link).

This 2012 paper provides an extensive analysis on the potential economic consequences of the Volcker Rule and concludes that the Rule will adversely affect bank customers and banks and will have a negative effect on market making and liquidity providing for many securities.

GAO, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented* (July 13, 2011) (link).

This report states that proprietary trading was not a proximate cause of the financial crisis and that "FDIC staff, whose organization oversees bank failures, said they were not aware of any bank failures that had resulted from standalone proprietary trading."

Oliver Wyman, *Implications of the Volcker Rule on the US Corporate Bond Market* (Dec. 2011) (link).

A 2011 Oliver Wyman report concluded that an overly restrictive implementation of the Volcker Regulations would "artificially limit banking entities' ability to facilitate trading, hold inventory at levels sufficient to meet investor demand, and actively participate in the market to price assets efficiently—reducing liquidity across a wide spectrum of asset classes."

SIFMA, et. al., *Comment Letter on Implementing the Volcker Rule—Proprietary Trading* (Feb. 13, 2012) (link).

The 173-page comment letter by SIFMA and other trade associations on the proposed Volcker Regulations' proprietary trading provisions describes in great detail the problems with the proposal and the ways in which SIFMA and the other trade associations believe that the proposal could have been reoriented to better achieve congressional intent.

SIFMA, et. al., *Comment Letter on Implementing the Volcker Rule—Hedge Fund and Private Equity Fund* (Feb. 13, 2012) (link) and *Supplemental Comment Letter* (Mar. 9, 2012) (link).

The 154-page comment letter by SIFMA and other trade associations on the proposed Volcker Regulations' covered fund provisions includes a number of recommended modifications, including functional definitions of a hedge fund and private equity fund. The supplemental comment letter filed by the same trade associations responds to certain specific requests for comment from the agencies in the covered funds portions of the proposed rules.

SIFMA Asset Management Group, *Comment Letter on the Volcker Rule* (Feb. 13, 2012) (link).

SIFMA's Asset Management Group's comment letter describes the negative impacts that the proposed Volcker Regulations would have on market liquidity.

Davis Polk & Wardwell LLP, *Volcker Rule Final Regulations: Proprietary Trading Flowcharts* (Dec. 23, 2013) (link).

The visual flowcharts summarize the proprietary trading provisions of the Volcker Rule regulations.

Davis Polk & Wardwell LLP, *Volcker Rule Final Regulations: Funds Flowcharts* (Jan. 6, 2014) (link).

The visual flowcharts summarize the covered fund provisions of the Volcker Rule regulations.

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E. Living Wills

Primary Sources

Federal Reserve and FDIC, *Resolution Plans Required* (Nov. 1, 2011) (link).

The agencies implemented Section 165(d) of the Dodd-Frank Act through a final rule that requires BHCs with total consolidated assets of $50 billion or more and nonbank financial companies designated by FSOC to annually submit a plan for its rapid and orderly resolution in the event of material financial distress or failure. The first living wills were filed in 2012, and since then over 500 living wills have been submitted to the agencies.

FDIC, *Resolution Plans at Large Insured Depository Institutions* (May 17, 2010) (link); and FDIC, *Resolution Plans – IDI Rule* (Jan. 23, 2012) (link).

The FDIC proposed a rule on resolution plans for IDIs in 2010 before the Dodd-Frank was enacted and issued an interim final rule in 2011. Despite the final rule implementing Section 165(d) of the Dodd-Frank Act above, the FDIC issued a duplicative revised final rule in 2012 that requires IDIs with $50 billion or more in total assets to submit annual IDI plans. IDIs have submitted over 100 separate resolution plans to the FDIC.

Federal Reserve and FDIC, *Guidance for Domestic Companies' 2013 §165(d) Resolution Plans* (Apr. 15, 2013) (link);
Federal Reserve and FDIC, *Guidance for Foreign Companies' 2013 §165(d) Resolution Plans* (Apr. 15, 2013) (link);
Federal Reserve and FDIC, *Guidance for Domestic Companies' 2017 §165(d) Resolution Plans* (Apr. 13, 2016) (link); and
Federal Reserve and FDIC, *Guidance for Foreign Companies' 2018 §165(d) Resolution Plans* (Mar. 24, 2017) (link).

In addition to the final rule, which contains specific requirements on what must be included living wills, the agencies have issued multiple rounds of guidance, none of which has not been subject to a public notice and comment period consistent with the requirements of the APA before becoming final. This guidance has imposed accretive requirements that not only increase the content required to be included in each living will, and therefore costs, but also impact business-as-usual operations. For example, recent guidance requires the largest banking organizations to develop new and burdensome modeling for resolution capital and liquidity needs. Some of the earlier guidance was issued in non-public letters.

Federal Reserve and FDIC, *Resolution Plan Assessment Framework and Firm Determinations* (Apr. 13, 2016) (link);
Federal Reserve and FDIC, *Determinations on October 2016 resolution plan submissions* (Dec. 13, 2016) (link); and
Federal Reserve and FDIC, *Determinations on December 2015 resolution plan submissions* (Mar. 24, 2017) (link).

Although the agencies have received over 500 living wills under the final rule, only five living wills have been jointly deemed not credible. The agencies have since found that all five of these banking organizations had remediated the deficiencies in their living wills. Most recently, the agencies did not find living wills submitted by sixteen domestic banks to be not credible.

FDIC and Bank of England, *Resolving Globally Active, Systemically Important Financial Institutions* (Dec. 2012) (link).

The U.S. and UK regulators' paper discuss the application of the SPOE strategy in their respective jurisdictions. In the United States, losses under the SPOE strategy would be assigned to the holding company's shareholders and unsecured creditors under the Bankruptcy Code or OLA, and the UK would use a statutory bail-in resolution tool. Sound operating entities would continue to operate under both applications of the SPOE strategy.

Bank of England, *The Bank of England's Approach to Resolution* (Oct. 2014) (link).

The Bank of England publicly disclosed its framework for resolving banks under the European Bank Recovery and Resolution Directive, including insight into what the regulator believes is most important for an orderly resolution. In particular, the Bank of England publicly stated that, where possible, it would use the SPOE strategy to resolve UK financial groups (para. 72 and Box 1) and publicly committed to use its resolution authority to ensure that financial stability is maintained in both the UK home and non-UK host jurisdictions (paras. 19 and 20).

GAO, *Resolution Plan Process Analysis* (Apr. 2016) (link).

This GAO report was highly critical of how the agencies have managed the living will process and makes suggestions for improvement, including public disclosure of the agencies' assessment framework and revision of the annual filing requirement to provide enough time for the agencies to review and provide feedback as well as provide banking organizations with enough time to respond to feedback in future living wills.

In response to the GAO report, House Financial Services Committee Chair Jeb Hensarling stated, "The secrecy and lack of accountability can lead to abuse by Washington regulators and is a tool for them to potentially exercise *de facto* management authority over major financial institutions. Once again we're seeing the uncertainty created by Dodd-Frank and its regulatory burden that impedes economic growth and makes it more difficult for working Americans to achieve financial independence."

Secondary Sources

Davis Polk & Wardwell LLP and McKinsey & Company, *Credible Living Wills: The First Generation* (Apr. 25, 2011) (link).

Before the agencies issued the final rule, Davis Polk and McKinsey released a white paper that discusses living wills' potential to be an effective tool for improving risk management, reducing systemic risk and mitigating the too big to fail as well as drawbacks and risks to living wills that need to be carefully considered. The white paper cautioned, "Getting living wills right both domestically and globally is a critical, high-stakes problem both for supervisors and regulated institutions."

SIFMA, et al., *Comment Letter on Proposed Rule Implementing Resolution Plan and Credit Exposure Report Requirements* (June 10, 2011) (link).

The comment letter by SIFMA and other trade associations proposed modifications to the proposed rule to make resolution planning more effective, stating, "We share the supervisors' goal that resolution planning should be viewed as a cooperative and iterative process between firms and supervisors that should evolve over time."

John Douglas, *Recent Developments in Resolution Planning (Living Wills)* (2016).

The presentation to the PLI Banking Law Institute discusses recent living wills developments, including the operationalization of the SPOE strategy through secured support agreements, the IHC structure and projection-based triggers.

John Douglas and Randall D. Guynn, *Resolution of US Banks and Other Financial Institutions*, in Debt Restructuring (Rodrigo Olivares-Caminal, et al. eds., 2d ed. 2016).

In this chapter, John Douglas and Randall D. Guynn, partners at the law firm Davis Polk & Wardwell, provide a detailed overview of bank resolution in the United States and United Kingdom, including the OLA framework, the SPOE strategy and U.S. resolution planning requirements. With respect to resolution planning, the authors warn, "The US regulators have continued to issue new guidelines and expectations, which will probably continue to evolve over time. The increasing burden of new regulations will also continue to put downward pressure on the market value of the US G-SIBs."

Randall D. Guynn, *Resolution Planning in the United States*, in Andreas Dombret & Patrick S. Kenadjian eds., The Bank Recovery and Resolution Directive: Europe's Solution for "Too Big to Fail"? (2013).

In this chapter, Randall D. Guynn, partner at the law firm Davis Polk & Wardwell, provides a detailed analysis of the SPOE resolution model.

Simon Gleeson and Randall D. Guynn, Bank Resolution and Crisis Management: Law and Practice (2016).

The book provides a guide to new bank resolution regimes, including OLA and the living wills requirement in the United States, the European Bank Recovery and Resolution Directive and the UK Banking Act 2009.

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F. Derivatives

A complete bibliography for Title VII rulemakings and no-action letters is too extensive to list here. A list of Title VII rulemakings of the CFTC and SEC can be found on the CFTC website (link) and the SEC website (link). An expanded bibliography of SIFMA submissions can be found on the SIFMA website (link).

1. Background

G20, *Leaders' Statement, The Pittsburgh Summit* (Sept. 24–25, 2009) (link).
This statement sets forth an agreement among the G20 members to strengthen the regulation of OTC derivatives through key reforms.

G20, *Cannes Summit Final Declaration* (Nov. 4, 2011) (link).
This statement sets forth further agreements among the G20 members to strengthen the regulation of OTC derivatives through key reforms.

Bank for International Settlements, Semi-annual *OTC Derivatives Statistics at End-June 2016* (Nov. 2016) (link).
This is the Bank for International Settlement's most recent survey regarding the OTC derivatives markets.

Apanard Prabha et al., *Deriving the Economic Impact of Derivatives* (Mar. 2014) (link).
This report provides an analysis of the economic impact of derivatives, finding significant contributions to U.S. GDP.

Hester Peirce, *Regulating through the Back Door at the [CFTC]* (Nov. 2014) (link).
This paper describes the CFTC's use of staff guidance, no-action letters and enforcement actions to dictate policy outside the rulemaking process.

ISDA, *SwapsInfo Weekly Analysis* (Apr. 7, 2017) (link).
This report summarizes the significant changes and progress made in the OTC derivatives markets.

ISDA, *Cross-Border Fragmentation of Global Interest Rate Derivatives: Second Half of 2015 Update* (May 2016) (link).
This report shows how the extraterritorial fragmentation of U.S. SEF regulation fragments the interest rate derivatives market.

PricewaterhouseCoopers, *Global Financial Markets Liquidity Study* (Aug. 2015) (link).
This PricewaterhouseCoopers study addresses changes in financial market liquidity following various regulatory reforms.

Bank for International Settlements, *Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms* (Aug. 2013) (link).

This research assesses the costs and potential benefits of OTC derivatives reform.

William C. Meehan and Gabriel D. Rosenberg, *OTC Derivatives Regulation Under Dodd-Frank: A Guide to Registration, Reporting, Business Conduct, and Clearing* (2016).

This book summarizes the changing OTC derivatives regulatory regime and raises key issues with which market participants are struggling.

2. Cross-Border Implications

Primary Sources

CFTC, *Cross-Border Regulation of Swaps/Derivatives Discussions between the [CFTC] and the European Union—A Path Forward* (July 11, 2013) (link).

This statement from the CFTC and the European Commission established the strictest rule applies principle.

CFTC, *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations* (July 26, 2013) (link).

This is the CFTC's guidance regarding the cross-border application of Title VII, which established the most far-reaching cross-border framework ever attempted under U.S. financial market regulation without any related cost-benefit analysis.

CFTC, *Applicability of Transaction-Level Requirements to Activity in the United States*, Staff Advisory No. 13-69 (Nov. 14, 2013) (link).

This CFTC staff advisory, which was published with immediate effectiveness without undergoing any public comment process, expanded the application of Title VII to swaps between non-U.S. persons arranged, negotiated or executed by U.S.-located personnel. The CFTC subsequently published temporary no-action relief effectively suspending the advisory and solicited public comment.

SEC, *Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities* (Aug. 12, 2014) (link).

The SEC conducted a series of rulemakings to establish its own cross-border framework for Title VII, including this rulemaking addressing the cross-border application of registration requirements.

SEC, *Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed By Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception* (Feb. 19, 2016) (link).

This subsequent SEC rulemaking applied registration requirements on the basis of using U.S. personnel to arrange, negotiate or execute transactions between non-U.S. persons.

CFTC, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements* (May 31, 2016) (link).

This rulemaking addressed the cross-border application of the CFTC's margin rules, expanding those rules to apply extraterritorially even more broadly than what was contemplated by the CFTC's 2013 cross-border guidance.

CFTC, *Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants* (Oct. 18, 2016) (link).

This proposed rulemaking would extend the CFTC's cross-border framework for its margin rules to its registration rules.

Secondary Sources

Coalition for Derivatives End-Users, *Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants* (Dec. 19, 2016) (link).

In this comment letter, the U.S. Coalition for Derivatives End-Users requested that the CFTC refrain from moving forward with the "foreign consolidated subsidiary" concept which, if adopted, would impede the ability for U.S. companies to hedge commercial risks outside of the United States.

Investment Company Institute and ICI Global, *Comment Letter on Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants* (Aug. 21, 2013) (link).

In this comment letter, the Investment Company Institute and ICI Global emphasized the importance of global coordination among derivatives regulators in order to avoid imposing duplicative costs on market participants which would impede cross-border derivatives transactions.

Coalition for Derivatives End-Users and European Association of Corporate Treasurers, *Letter* (July 11, 2013) (link).

In this letter, the U.S. Coalition for Derivatives End-Users and European Association of Corporate Treasurers requested that global regulators coordinate implementation of derivatives reforms to avoid fragmentation of the global derivatives markets.

Investment Company Institute and ICI Global, *Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act* (Aug. 23, 2012) (link).

In this letter, the Investment Company Institute and ICI Global argue that the application of U.S. regulation to non-U.S. companies OTC derivatives transactions could cause them to cease trading with U.S. companies.

Coalition for Derivatives End-Users, ***Comment Letter on Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of Non-U.S. Swap Dealers Located in the United States*** **(Mar. 10, 2014) (link).**

In this comment letter, the Coalition of Derivatives End-Users argue that non-U.S. end-users would avoid trading with non-U.S. swap dealers using U.S. personnel, thus reducing available liquidity, if doing so would subject them to duplicative regulatory requirements.

Global Financial Markets Association, ***Comment Letter on the Proposed Interpretive Guidance on the Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act and the Proposed Exemptive Order Regarding Compliance with Certain Swap Regulations*** **(Aug. 13, 2012) (link).**

In this comment letter, the Global Financial Markets Association argued for a robust regulatory recognition approach to cross-border regulation.

SIFMA, ***Comment Letter on the Proposed Interpretive Guidance on the Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act*** **(Aug. 27, 2012) (link).**

In this comment letter, SIFMA expressed concern with several aspects of the CFTC's proposed cross-border guidance, including the respects in which the guidance exceeded statutory limits on the CFTC's jurisdiction, upset the level playing field in the swaps markets and incorporated an unduly narrow substituted compliance regime.

SIFMA, the Futures Industry Association and the Financial Services Roundtable, ***Comment Letter on the Proposed Rules and Interpretive Guidance Addressing Cross-Border Security-Based Swap Activities, the Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*** **(Aug. 21, 2013) (link).**

In this comment letter, SIFMA, the Futures Industry Association and the Financial Services Roundtable expressed concerns with the SEC's proposal to apply its rules to non-U.S. transactions conducted within the United States by U.S.-located personnel.

SIFMA and the Institute of International Bankers, ***Comment Letter on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements*** **(Sept. 14, 2015) (link).**

In this comment letter, SIFMA and the Institute of International Bankers identified the adverse consequences on competition and market integration arising from overlapping, extraterritorial margin regulation.

SIFMA Asset Management Group, ***Comment Letter on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements*** **(Sept. 14, 2015) (link).**

In this comment letter, SIFMA's Asset Management Group argued for a less complex cross-border margin framework that would limit overlapping rules.

SIFMA and the Institute of International Bankers, ***Comment Letter on Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants*** **(Dec. 19, 2016) (link).**

In this comment letter, SIFMA and the Institute of International Bankers expressed concerns that the CFTC's proposal to expand extraterritorial regulation of foreign branches and foreign consolidated subsidiaries would exceed the CFTC's legal authority and adversely affect the markets and American companies.

American Bankers Association, Coalition for Derivatives End-Users, the Financial Services Roundtable, ISDA, National Association of Corporate Treasurers, SIFMA and the U.S. Chamber of Commerce Center for Capital Markets Competitiveness, ***Comment Letter on Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants*** **(Dec. 19, 2016) (link).**

In this comment letter, a wide range of trade associations expressed additional concerns regarding the CFTC's proposal to expand extraterritorial regulation of foreign branches and foreign consolidated subsidiaries.

Edward J. Rosen, et al., ***Application of OTC Derivatives Regulation to Foreign Banks*****, in Regulation of Foreign Banks and Affiliates in the United States (Randall D. Guynn ed., 9th ed. 2016).**

In this chapter, Edward J. Rosen, a partner at the law firm Cleary Gottlieb Steen & Hamilton, and others discuss the regulation of OTC derivatives, including the swaps pushout rule and Title VII.

Robert J. Dilworth and Colin Lloyd, ***Bumps on the Path Forward*** **(Dec. 11, 2013) (link).**

The authors discuss developments within the U.S. and EU regulations of the futures and securities markets.

3. Margin Requirements

Primary Sources

Basel Committee and International Organization of Securities Commissions, ***Margin Requirements for Non-centrally-cleared Derivatives – Consultative Document*** **(July 2012) (link).**

This is the initial consultation on international margin standards.

SEC, ***Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*** **(Nov. 23, 2012) (link).**

This is the SEC's proposal regarding capital, margin and segregation requirements for security-based swaps, which the SEC has not yet finalized.

Basel Committee and International Organization of Securities Commissions, ***Margin Requirements for Non-centrally-cleared Derivatives – Second Consultative Document*** **(Feb. 2013) (link).**

This is the second consultation on international margin standards, which describes the results of regulators' quantitative impact study.

Basel Committee and International Organization of Securities Commissions, *Margin requirements for non-centrally-cleared derivatives* (Mar. 2015) (link).
These are the final international margin standards.

U.S. Banking Agencies, FCA and FHFA, *Margin and Capital Requirements for Covered Swap Entities* (Nov. 30, 2015) (link).
These are the U.S. Prudential Regulators' final margin rules for swap dealers that are banks.

CFTC, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants* (Jan. 6, 2016) (link).
These are the CFTC's final margin rules for non-bank swap dealers.

Secondary Sources

J. Christopher Giancarlo, *Opening Statement on Open Meeting on Proposed Rule on Margin Requirements for Uncleared Swaps and Final Rule on Utility Special Entities* (Sept. 17, 2014) (link).
In this statement, Commissioner Giancarlo noted that no rigorous analysis informed the determination to apply a 10-day margin period of risk requirement for non-cleared swaps.

BlackRock, Inc., *Comment Letter on Proposed Margin Requirements for Uncleared Swaps* (July 11, 2011) (link).
In this comment letter, BlackRock provided quantitative analysis underscoring issues with the proposed 10-day margin period of risk requirement for non-cleared swaps.

PIMCO, *Comment Letter on Issues Arising from Margin Requirements for Covered Swap Entities as Proposed by the Prudential Regulators and CFTC* (July 11, 2011) (link).
In this comment letter, PIMCO explained why proposed margin rules for non-cleared swaps are not appropriately risk-sensitive.

SIFMA, *Comment Letter on Consultative Document: Margin Requirements for Non-Centrally-Cleared Derivatives* (Sept. 28, 2012) (link).
In this comment letter, SIFMA described the conceptual flaws and negative consequences of universal two-way initial margin requirements.

SIFMA, *Comment Letter on Second Consultative Document: Margin Requirements for Non-Centrally-Cleared Derivatives (February 2013)* (Mar. 15, 2013) (link).
In this comment letter, SIFMA described serious methodological flaws with the quantitative impact study that was the foundation for margin requirements for non-cleared swaps.

Coalition for Derivatives End-Users, *Comment Letter on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants* (Dec. 2, 2014) (link).

In this comment letter, the Coalition for Derivatives End-Users argued that the costs of posting initial margin incurred by swap dealers will ultimately be passed on to end-users.

Luke Zubrod, *Statement at the Hearing to Review the Impact of G-20 Clearing and Trade Execution Requirements* (June 14, 2016) (link).

In his statement, Luke Zubrod, Director of Chatham Financial, described the high cost of clearing and non-cleared swaps margin for low-volume users.

SIFMA, ISDA and Institute of International Finance and Association for Financial Markets in Europe, *Comment Letter on Margin Requirements for Non-Centrally-Cleared Derivatives* (Apr. 12, 2013) (link).

In this comment letter, SIFMA, ISDA and the Institute of International Finance and the Association for Financial Markets in Europe described serious issues with initial margin requirements for non-cleared swaps, including using those requirements to create outsized incentives for central clearing.

SIFMA, *Comment Letter on Margin and Capital Requirements for Covered Swap Entities; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants* (Nov. 24, 2014) (link).

In this comment letter, SIFMA identified several problematic aspects of the proposed margin rules, including the treatment of inter-affiliate swaps and operational aspects of the rules.

SIFMA, The Clearing House, American Bankers Association and ABA Securities Association, *Comment Letter on Margin and Capital Requirements for Covered Swap Entities* (June 1, 2015) (link).

In this comment letter, SIFMA, The Clearing House, American Bankers Association and ABA Securities Association described the adverse effects of applying initial margin requirements to inter-affiliate swaps.

Cleary Gottlieb Steen & Hamilton LLP, *Agencies Finalize Margin Rules for Non-Cleared Swaps and Security-Based Swaps* (Jan. 28, 2016) (link).

This client memorandum summarizes the November 2015 and January 2016 final margin rules.

4. Clearing and Trading Requirements

Primary Sources

SEC, *Registration and Regulation of Security-Based Swap Execution Facilities* (Feb. 28, 2011) (link).

This proposal addressed the SEC's regulation of security-based SEFs, which did not include several of the prescriptive elements of the CFTC's SEF regime.

CFTC, *Clearing Requirement Determination Under Section 2(h) of the CEA* (Dec. 13, 2012) (link).
This rulemaking established clearing requirements for specified interest rate swaps and credit default swaps.

CFTC, *Clearing Exemption for Swaps Between Certain Affiliated Entities* (Apr. 11, 2013) (link).
This CFTC rulemaking established an inter-affiliate clearing exemption, which incorporated numerous conditions to the relief.

CFTC, *Core Principles and Other Requirements for Swap Execution Facilities* (June 4, 2013) (link).
This rulemaking established the CFTC's regulatory regime for SEFs.

CFTC, *Clearing Requirement Determination Under Section 2(h) of the CEA for Interest Rate Swaps* (Oct. 14, 2016) (link).
This rulemaking expanded the CFTC's clearing requirement to interest rate swaps in several additional currencies, which has negatively affected the competitiveness of U.S. banks trading in foreign markets because it subjects them to broader clearing requirements than their local competitors.

Secondary Sources

SIFMA and ISDA, *Comment Letter on Core Principles and Other Requirements for Swap Execution Facilities* (Mar. 8, 2011) (link).
In this comment letter, SIFMA and ISDA expressed concerns regarding the CFTC's proposal to impose highly prescriptive limits on how SEFs can execute swaps.

SIFMA, ISDA and the Futures Industry Association, *Comment Letter on Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade* (Feb. 13, 2012) (link).
In this comment letter, SIFMA, ISDA and the Futures Industry Association expressed concerns that SEFs and designated contract markets should not be responsible for determining which swaps must be traded on SEFs.

SIFMA AMG, *Comment Letter on Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade* (Feb. 13, 2012) (link).
In this comment letter, the SIFMA's Asset Management Group urged the CFTC to work toward a more objective process for determining which swaps must be traded on SEFs.

SIFMA and ISDA, *Comment Letter on Clearing Exemption for Swaps between Certain Affiliated Entities Proposed Rule* (Sept. 20, 2012) (link).
In this comment letter, SIFMA and ISDA described issues raised by the conditions the CFTC proposed to apply to its inter-affiliate clearing exemption.

J. Christopher Giancarlo, *Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank* (Jan. 29, 2015) (link).

In this white paper, then-Commissioner Giancarlo diagnosed the fundamental mismatch between the CFTC's swaps trading regulatory framework and the distinct liquidity and trading dynamics of the global swaps market, described the ensuing adverse consequences and proposed an alternative swaps trading framework.

SIFMA, *Comment Letter on CFTC Title VII Swap Execution Facility and Trade Execution Regulatory Framework and Implementation* (Oct. 6, 2015) (link).

In this comment letter, SIFMA recommended several clarifications and enhancements to the CFTC's approach to package trades, swaps submitted for clearing, block trades and cross-border trades.

ISDA, *Principles for US/EU Trading Platform Recognition* (Feb. 24, 2016) (link).

In this paper, ISDA set forth a more outcomes-based approach to trading platform substituted compliance and recognition.

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G. Incentive Compensation

Primary Sources

Financial CHOICE Act of 2017 (Apr. 26, 2017) (link).

The CHOICE Act, currently under consideration in the House Financial Services Committee, provides a legislative means to repeal Section 956. A repeal is included in Section 857 of the current discussion draft.

U.S. Banking Agencies, FHFA, NCUA and SEC, *Incentive-based Compensation Arrangements Proposed Rule* (May 16, 2016) (link).

The preamble to the 2016 reproposed rule specifically acknowledged the rapid evolution of compensation practices since 2008, citing "incentive-based compensation practices and the design of incentive-based compensation arrangements at banking organizations supervised by the Federal Banking Agencies have improved significantly in the years since the recent financial crisis," continuing, "control functions frequently play an increased role in the design and operation of incentive-based compensation, and institutions have begun to build out frameworks to help validate the effectiveness of risk adjustment mechanisms."

The SEC's commentary in its portion of the preamble to the 2016 reproposed rule is particularly notable. There, the SEC observed that there are conflicting studies as to the link of compensation to risk-taking and pointed to multiple studies that take the position that compensation structures were not responsible for dysfunctional risk-taking and performance of financial institutions during the crisis.

The SEC also noted that the 2016 reproposed rule might itself have unintended consequences including "potential negative effects on efficiency and shareholder value" and "losses of managerial talent that may migrate from covered institutions to firms in different industries or abroad."

Financial Stability Board, *Implementing the FSB Principles for Sound Compensation Practices and Their Implementation Standards, Fourth Progress Report* (Nov. 10, 2015) (link).

The Financial Stability Board, in a report on the evolution of compensation structures at financial institutions, noted that "significant banks have strengthened risk management processes and governance structures, including a more prominent and formalized role for the risk function in decisions regarding the alignment of compensation with both ex ante risk and ex post performance."

Meeting between The Clearing House and the Federal Reserve (Sept. 14, 2015) (link).

Representatives from The Clearing House, certain banks and the Federal Reserve discussed conclusions reached from an anonymous survey of 16 Clearing House members strong changes in compensation practice, stating, "This could impact the ability of financial services firms to attract and retain talent, since there firms already compete for talent against a wide variety of firms that would not be subject to these requirements. . . . The attendees would prefer that any interagency rule or guidance retain flexibility for firms."

Financial Stability Board, *Implementing the FSB Principles for Sound Compensation Practices and Their Implementation Standards, Third Progress Report* (Nov. 4, 2014) (link).

The Financial Stability Board has periodically reported on the evolution of compensation structures at financial institutions since the financial crisis. In its third progress report, the FSB noted that "All authorities report that significant financial institutions have continued to improve their governance frameworks for compensation, and better practices are observed in terms of ex ante risk adjustment of compensation to reflect risk-taking."

CFPB, *Loan Originator Compensation Requirements Under the Truth in Lending Act (Regulation Z)* (Feb. 15, 2013) (link).

Regulation Z is an example of a regulation issued in the wake of the financial crisis that is reasonably tailored to cover only those individuals who can expose an institution to the risk of material loss and to cover only incentive compensation programs that involve inappropriate risk. The regulation prohibits loan originators from receiving "compensation in an amount that is based on a term of a transaction, the terms of multiple transactions by an individual loan originator, or the terms of multiple transactions by multiple individual loan originators."

Federal Reserve, *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Institutions* (Oct. 2011) (link).

The Federal Reserve's 2011 horizontal review acknowledged that "the large banking organizations in the review have made significant progress toward enhancing their incentive compensation arrangements, in ways that provide appropriately balanced incentives to take risks" and went on to note how "the interagency guidance helps to avoid the potential hazards or unintended consequences that would be associated with rigid, one-size-fits-all supervisory limits or formulas."

Baird Webel, Congressional Research Service, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Issues and Summary* (July 29, 2010) (link).

The report notes that the Dodd-Frank Act's initiatives to regulate compensation, including Section 956, "are significantly premised on the widely held belief that large financial firm incentive pay structures significantly contributed to excessive risk taking. However, at least one major academic study has raised questions about this premise."

U.S. Banking Agencies, *Guidance on Sound Incentive Compensation Policies* (June 10, 2010) (link).

The 2010 interagency guidance explicitly acknowledged the shortcomings of a one-size-fits-all approach, stating, "the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to result in arrangements that are unbalanced at least with respect to some employees."

Senate Banking Committee, *Report on the Restoring American Financial Stability Act* (Apr. 30, 2010) (link).

The report notes that statutory mandate of Section 956 is proscriptive rather than prescriptive, and meant to apply existing regulatory authority, stating, "Section 956 amends Section 5 of the Bank Holding Company Act of 1956 to establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company that provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits; or could lead to material financial loss to the bank holding company. This applies regulatory authority currently applicable to banks to their holding companies."

SEC, *Proxy Disclosure Enhancements* (Dec. 23, 2009) (link).

Regulation S-K Item 402(s) is an example of a regulation that is reasonably tailored in its application to cover only individuals who can expose an institution to the risk of material loss and to cover only incentive compensation programs that involve inappropriate risk. Item 402(s) requires the disclosure by public companies of any risks related to their compensation policies and practices to the extent they are "reasonably likely to have a material adverse effect on the registrant."

Secondary Sources

FSB-IOSCO, *FSB-IOSCO Roundtable on Compensation Practices in the Securities Sector* (Apr. 6, 2017) (link).

In December 2016, members of the FSB's Compensation Monitoring Contact Group and IOSCO's Compensation Experts Group held a roundtable with approximately 20 senior executives responsible for compensation in internationally active securities firms. As a recent summary reported, "Industry participants were of the view that there is no direct link between compensation in asset management and financial stability. This is mainly because the use of own balance sheet and leverage is highly limited in traditional asset management business."

SIFMA, *Comment Letter on 2016 Reproposed Rules* (July 22, 2016) (link).

The comment letter submitted by SIFMA noted that the 2016 reproposed rules are fatally flawed and exceed the statutory mandate, stating, "The Reproposed Rule breaks sharply from the conclusions expressed in the Final Interagency Guidance by advancing an intensely prescriptive approach to regulation. . . . We respectfully submit that the Safety and Soundness Guidelines promulgated under Section 39 (the 'Safety and Soundness Guidelines') do explicitly provide a standard under Section 39 for determining whether compensation arrangements may encourage inappropriate risks."

American Bankers Association, et al., *Comment Letter on 2016 Reproposed Rules* (July 22, 2016) (link).

The comment letter submitted by SIFMA and other trade associations noted that the 2016 reproposed rules would lead to talent acquisition and retention arbitrage, stating, "The Agencies should also closely consider whether the type of talent incentive-based compensation arrangements are designed to attract will be likely to leave covered industries in favor of non-covered industries. Will a technology expert hired by a financial institution to oversee development of a new customer-friendly mobile interface leave the bank in favor of a pure tech company so as not to be subject to deferral and clawback? . . . Of real concern is the distinct possibility that Section 956 actually weakens the financial stability of the economy by impeding the ability of firms to attract and retain top talent."

Financial Services Roundtable, *Comment Letter on 2016 Reproposed Rules* (July 22, 2016) (link).

The comment letter submitted by the Financial Services Roundtable noted that the reproposed rules exceed the statutory mandate, and would put the regulated financial services industry at a competitive disadvantage in retaining and recruiting employees, stating, "Nothing in the statutory language compels, or even suggests that Congress intended the Statute to create the level of prescriptive detail that is set forth in the Proposal. The Proposal contains numerous, detailed and complex requirements and would impose extraordinary and unprecedented limitations on the incentive-based compensation arrangements of most Covered Institutions. . . . The impact of the Proposal may best be illustrated by the ability of a competitor to only pay an employee as little as 41 cents in incentive compensation to provide more immediate benefit to an employee than a dollar of incentive compensation provided from a Covered Institution if the Proposal were to be adopted."

National Financial Services LLC, *Comment Letter on 2016 Reproposed Rules* (July 21, 2016) (link).

The SEC itself has recognized potential issues with the 2016 reproposed rule, as highlighted by National Financial Services LLC in its comment letter: "In addition to not producing the intended benefits, the SEC importantly recognizes that the Proposed Rule may have unnecessary adverse consequences if it is applied to institutions that are able to contract efficiently for compensation arrangements. In particular, unintended consequences may include curbing risk-taking incentives to a sub-optimal level, with consequent negative effects on efficiency and shareholder value. Further, applying the Proposed Rule in this scenario may result in losses of managerial talent that may migrate from covered institutions to firms in different industries or foreign jurisdictions."

The Clearing House, *Comment Letter on 2016 Reproposed Rules* (July 22, 2016) (link).

The comment letter submitted by The Clearing House notes that the reproposed rules are in tension with the statute and depart from the regulatory agencies' existing policy view on incentive compensation, stating, "The proposal would ignore the findings underlying the 2010 Guidance and Section 956, as well as the considerable investments covered institutions have made to implement it. Instead, the proposal would adopt the type of 'one size fits all' approach that commentators warned against and the Agencies specifically rejected."

The Risk Management Association, *Comment Letter on 2016 Reproposed Rules* (July 20, 2016) (link).

The Risk Management Association provides independent analysis on matters pertaining to risk management and capital regulation. As RMA observed in its comment letter, "We are concerned that the Proposed Rule seeks to implement a uniform approach contrary to stated regulatory intent, which could have significant unintended consequences, including, but not limited to, market-wide liquidity dampening, credit market tightening, flight of talent to fintechs and less regulated areas, and stifling of innovation."

U.S. Chamber of Commerce, *Comment Letter on 2016 Reproposed Rules* (July 21, 2016) (link).

The comment letter submitted by the U.S. Chamber of Commerce noted that the reproposed rules exceed the scope of the Dodd-Frank Act and will harm the financial services industry, stating, "Section 956 of the Dodd-Frank Act confers upon the Agencies the limited authority to prohibit incentive-based compensation plans that provide 'an executive officer, employee, director, or principal shareholder' of a covered institution with 'excessive compensation, fees, or benefits,' or that 'could lead to material financial loss' to the institution. The statute does not authorize the Agencies to prescribe terms and features of government-approved compensation plans." "Given the choice between working at a company that pays a flat salary no matter how well the worker performs compared to his peers, and a company that pays for success, most employees would choose the meritocratic firm."

Portia Crowe and Andy Kiersz, *Wall Street Isn't What It Used To Be*, Business Insider (June 22, 2016) (link)

The 2016 reproposed rule could have significantly increase the risk of talent drain from financial institutions. This risk was already substantial. As Business Insider has reported, careers at bulge-bracket banks or global financial institutions have grown less attractive to MBA students since 2010.

Donna Borak, Andrew Ackerman and Christina Rexrode, *New Rules Curbing Executive Pay Proposed*, Wall Street Journal (Apr. 22, 2016) (link)

Observers have noted that the 2016 reproposed rule could have severe unintended effects. As the Wall Street Journal reported: "If federal regulators influence clawback decisions, "there's a high probability it will drive people out of the heavily regulated part of the financial-services industry, said Alan Johnson, managing director of Johnson Associates Inc., a compensation consulting firm that closely tracks Wall Street. To retain talent, banks and other affected institutions will just have to pay more" (internal quotation marks omitted).

Nathaniel Popper, *Wall St. Regulators Propose Stricter Pay Rules for Bankers*, N.Y. Times (Apr. 21, 2016) (link)

The New York Times noted how the 2016 reproposed rule could exacerbate talent drain, reporting, "The proposals leave many financial firms, including large asset managers and hedge funds, shielded from the new restrictions because of the way the regulators have defined which institutions are subject to them. Young Wall Street workers, and potential recruits who might once have aspired to jobs in the industry, are already decamping for less regulated corners of finance and corporate America, including Silicon Valley."

Rob Copeland and Daisy Maxey, *New Wall Street Pay Rules a Win for Hedge Funds, Mutual Funds*, Wall Street Journal (Apr. 21, 2016) (link)

As the financial press has recognized, certain firms appear to have "escape[d] the most onerous restrictions of the rules." Such a discrepancy heightens the risk of talent drain.

Christina Rexrode, Justin Baer and Rachel Louise Ensign, *One Expected Casualty of New Compensation Rules: Banker Bonuses*, Wall Street Journal (Apr. 21, 2016) (link)

Again discussing the issue of talent drain, the Wall Street Journal reported that "Big U.S. banks are already struggling to keep top talent from decamping for Silicon Valley or hedge funds. Thursday's proposed new rules on banker pay aren't likely to help."

Meridian Compensation Partners, LLC, *Executive Compensation In The Banking Industry – Emerging Trends and Best Practices for 2014-2015* (June 22, 2015) (link).

Meridian Compensation Partners, a respected compensation consulting firm, has noted significant changes to executive compensation practices in the banking industry, including clawback policies and forfeiture provisions.

Ing-Haw Cheng, Harrison Hong and Jose A. Scheinkman, *Yesterday's Heroes: Compensation and Risk at Financial Firms* (Apr. 2015) (link).

The SEC attempted a cost-benefit analysis when adopting the 2016 reproposed rule. As part of this cost-benefit analysis, the SEC pointed to multiple studies that found that compensation structures were not responsible for the dysfunctional risk-taking and performance of financial institutions during the crisis. Cheng, Hong and Scheinkman authored one such study, finding that efficient contracting theory predicts that managers in companies facing greater amounts of uncontrollable risk would require higher levels of compensation.

Institute of International Finance and Oliver Wyman, *Compensation Reform: Embedding Global Standards* (Oct. 2013) (link).

In 2013, a joint Oliver Wyman/Institute of International Finance study reported on the changes made to compensation practices since 2008, stating, "some in the industry fear that policymakers will pursue further legislative interventions, driven by a perception that the industry has not yet changed. The results of this survey indicate that the industry has in fact made fundamental changes in policies and practices in line with the FSB Standards and in ways that foster institutional resilience and financial stability."

Rüdiger Fahlenbrach, Robert Prilmeier and René M. Stulz, *This Time is the Same: Using Bank Performance in 1998 to Explain Bank Performance During the Recent Financial Crisis* (Oct. 2011) (link).

As the SEC noted in the preamble to the 2016 reproposed rule, there are conflicting studies as to the link of compensation to risk-taking. Fahlenbrach, Prilmeier and Stulz provide one such study, finding that the poor performance of certain banks during the recent financial crisis was tied to leverage, not compensation.

Davis Polk & Wardwell LLP, *Bank Supervisory Agencies; Final Guidance: Aligning Incentive Compensation with Safety and Soundness Concerns* (June 29, 2010) (link).

Davis Polk summarizes a few differences between the 2010 interagency guidance and the 2009 proposed guidance from the Federal Reserve.

SIFMA, *Comment Letter on 2011 Proposed Rules* (May 31, 2011) (link).

The comment letter submitted by SIFMA applauded the principles-based approach but recognized that the interagency guidance already addressed the same issues and that having duplicative regulation is not efficient, stating, "The Proposed Rules and the Interagency Guidance are two attempts to deal with the same fundamental policy issues. We believe that the Interagency Guidance, in adhering to a principles-based approach coupled with effective supervision, have worked successfully to address the issues of concern to all parties involved. . . . [T]he substantive provisions contained in Section 956(b) of the Dodd-Frank Act, which are inherently more vague and require the application of discretion and judgment, should be implemented in the form of guidelines."

Rüdiger Fahlenbrach and René M. Stulz, *Bank CEO Incentives and the Credit Crisis* (Aug. 2010) (link).

As noted by the Congressional Research Service, Fahlenbrach and Stulz's research "raise[s] questions concerning the premise" underlying certain post-crisis efforts to regulate incentive compensation. As Fahlenbrach and Stulz write, "Based on our evidence, lack of alignment of bank CEO incentives with shareholder interests cannot be blamed for the credit crisis or for the performance of banks during that crisis. . . . For the whole sample, neither cash bonus nor stock options had an adverse impact on bank performance during the crisis."

John E. Core and Wayne R. Guay, *Is There a Case for Regulating Executive Pay in the Financial Services Industry* (link).

Core and Guay raise serious reservations about whether regulatory proposals to regulate compensation as drafted would achieve their stated objectives, noting that the rhetoric favoring additional regulation does not rely on "evidence or careful analysis as to why existing compensation practices are flawed (since there is little clear evidence that arrangements are systematically flawed)."

Davis Polk & Wardwell LLP, *Federal Reserve Proposed Guidance: Aligning Incentive Compensation with Safety and Soundness Concerns* (Oct. 27, 2009) (link).

As Davis Polk noted when the Federal Reserve first released its proposed guidance on incentive compensation, "The Federal Reserve's framework . . . is relatively nuanced, is grounded in principles rather than rules and allows for considerable judgment and variation." Davis Polk further observed that the proposed guidance "avoid[ed] blunt instruments" and directed management to "craft compensation programs that are appropriate for their organizations." The 2010 interagency guidance generally made only modest changes to the Federal Reserve's 2009 proposal.

Daniel K. Tarullo, *Senate Banking Subcommittee Testimony on modernizing financial regulation* (Sept. 30, 2009) (link).

Tarullo testified before the Congress that there is a need to account for particular business circumstances, stating, "So our approach, I think, has been to want a rigorous internal process in firms in which the onus is on them to develop the right kinds of compensation contracts and provisions, taking into account their particular business and the kinds of responsibilities their employees have, but that those specific policies and practices need to be consistent with the overall goals of risk-appropriate incentive-based compensation."

Barney Frank, *Introduction of the Corporate and Financial Institution Compensation Fairness Act of 2009* (July 31, 2009) (link).

Barney Frank, former House Financial Services Committee Chairman, noted in Congress that the statutory mandate is limited and clawbacks should not be unreasonably arbitrary, stating, "It is limited in its grant of authority only to structures that incentivize excessive risk. There is no mandate here to set wages for anybody. There is no mandate to say this percentage is bonuses and that percentage is pay incentives. It is a mandate only to act where the structure incentivizes risk, as has been recognized as part of the problem, very broadly. . . . What the gentleman was concerned about, and I think legitimately, was the possibility of a callback; that is, a requirement that people give back bonuses they'd already received. That would be arbitrary. Now, we hope that there will be rules adopted that will set those rules in place, and I agree that there should not be people's pay subjected unreasonably to arbitrary retroactive decisions."

Society of Corporate Secretaries and Governance Professionals, ***Comment Letter on Reconsideration of Pay Ratio Rule Implementation*** **(Mar. 24, 2017) (link).**

In addition to the potential burdens imposed by Section 956, other Dodd-Frank executive compensation provisions also impose substantial costs without corresponding benefits. As the Society notes, "The [Pay Ratio] Rule does not provide material information to investors and obfuscates information that investors actually do deem material to their investment decisions . . . the Rule imposes significant direct and indirect costs to companies in the forms of data gathering and systems costs, legal expense, auditing expense, public relations expense, litigation risk and other costs."

Business Roundtable, ***Comment Letter on Reconsideration of Pay Ratio Rule Implementation*** **(Mar. 23, 2017) (link).**

In addition to the potential burdens imposed by Section 956, other Dodd-Frank executive compensation provisions also impose substantial costs without corresponding benefits. For example, the Business Roundtable has pointed out significant issues with the SEC's pay ratio rule issued under Section 953, stating, "The requirement that a company disclose the ratio of its CEO's compensation to that of its median employee, however, is not only immaterial to investors when evaluating a company's overall executive compensation, it also is both costly and harmful to companies, employees and investors."

Davis Polk & Wardwell LLP, ***Comment Letter on Reconsideration of Pay Ratio Rule Implementation*** **(Mar. 23, 2017) (link).**

Though this letter focuses on Section 956, other executive compensation provisions in the Dodd-Frank Act also do not align with the Core Principles. The Section 953(b) pay ratio, rule, for example, imposes burdensome information obligations that do not provide new disclosure that would be material to any investor's investment decision. As Davis Polk notes, compliance costs in many cases are anticipated to be "significantly in excess of the Commission's estimated initial cost of compliance."

U.S. Chamber of Commerce Center for Capital Markets Competitiveness, ***Comment Letter on Reconsideration of Pay Ratio Rule Implementation*** **(Mar. 23, 2017) (link).**

In addition to its comments on Section 956, the Chamber has also raised concerns about rules issued by the SEC under Section 953(b), noting that "The pay ratio rule fails to promote investor protection because it provides no benefits for investors; it adversely impacts the ability of American companies, particularly those with a large overseas presence, to compete in a global economy; it makes it more difficult for businesses to engage in efficient capital formation; and, in combination with other nonmaterial disclosures mandated by the Dodd-Frank Act, the rule makes the public company structure a less attractive business model, harming investors and the overall economy."

Davis Polk & Wardwell LLP, *SEC Adopts Final Pay Ratio Disclosure Rule* (Aug. 10, 2015) (link).
The SEC's pay ratio rule issued under Section 953(b) imposes substantial costs without corresponding benefits and could adversely affect the ability of American companies to compete in a global economy. Here, Davis Polk provides a question and answer overview of the pay ratio rule.

Davis Polk & Wardwell LLP, *SEC Proposes Dodd-Frank Clawback Rule* (July 8, 2015) (link).
As Davis Polk noted in a 2015 client memorandum, the clawback rule issued under Section 954 of the Dodd-Frank Act "is fairly prescriptive and goes beyond a number of requirements mandated by the statute." The clawback rule, like the 2016 reproposed rule, does not align with the Core Principles. A better course is to leave the substance of the Section 954 clawback rule to companies to implement in a manner that is tailored to their individual circumstances, which can be done after consideration of, among other factors, shareholder engagement.

Davis Polk & Wardwell LLP, *SEC Proposes Hedging Disclosure Rule* (Feb. 11, 2015) (link).
A number of the other Dodd-Frank executive compensation provisions do not align with the Core Principles. These provisions impose burdensome information obligations without providing new disclosure that would be material to any investor's investment decision. Here, Davis Polk discusses one example of such a rule: the hedging disclosure rule issued under Section 955.

Davis Polk & Wardwell LLP, *Visual Memorandum on Incentive Compensation for Financial Institutions: Reproposal* (May 12, 2016) (link).
This visual memorandum provides an overview and discusses key aspects of the proposed incentive compensation rule as of May 2016.

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H. Key Topics in Banking Regulation

1. Commodities & Merchant Banking

Primary Sources

Federal Reserve, *FHC Physical Commodities Activities Proposed Rule* (Sept. 30, 2016) (link).
The Federal Reserve's proposed rule would impose punitive capital requirements and other restrictions on certain physical commodities activities of FHCs.

Federal Reserve, *FHC Physical Commodities Activities Advance Notice of Proposed Rulemaking* (Jan. 21, 2014) (link).
The Federal Reserve foreshadowed many aspects of the proposed rule in its 2014 ANPR.

U.S. Banking Agencies, *Report Pursuant to Section 620 of the Dodd-Frank Act* (Sept. 9, 2016) (link).
The Federal Reserve and the other banking agencies were required by Section 620 of the Dodd-Frank Act to publish a report to Congress and the FSOC on the activities and investments that banking

entities may engage in under state and federal law. The Federal Reserve recommended in this report that Congress amend the BHC Act to repeal certain authorities under which FHCs engage in commodities activities, including all merchant banking authority under section 4(k)(4)(H) of the BHC Act. As of this date, Congress has not acted on the Federal Reserve's recommendations and the U.S. Treasury has not agreed to any amendments to the regulations relating to merchant banking activities (over which Congress explicitly granted joint authority to the U.S. Treasury).

Secondary Sources

SIFMA and Institute of International Bankers, *Comment Letter on FHC Physical Commodities Activities Proposed Rule* (Feb. 17, 2017) (link).

SIFMA and Institute of International Bankers submitted this comment letter on the proposed rule, arguing that the Federal Reserve did not consider any of the public benefits of FHC's physical commodities activities and overstated the risks, without any evidence, of such activities.

The Clearing House et al., *Comment Letter on FHC Physical Commodities Activities Proposed Rule* (Feb. 21, 2017) (link).

The Clearing House, The American Bankers Association, the Financial Services Forum, the Financial Services Roundtable and Institute of International Bankers submitted this comment letter on the proposed rule, responding specifically to the prospect that the Federal Reserve raised regarding increasing risk-based capital charges for all merchant banking investments.

The Clearing House, *Supplemental Comment Letter on FHC Physical Commodities Activities Proposed Rule* (Mar. 10, 2017) (link).

The Clearing House submitted this supplemental comment letter on the proposed rule sharing the results of its data study on merchant banking. It found that the size and scope of merchant banking activities are significant to a degree not acknowledged by the Federal Reserve, the frequency with which FHCs exercise routine management or operation of merchant banking portfolio companies is extremely limited, there was no evidence of corporate veil-piercing and that current risk-based capital requirements are more than sufficient.

SIFMA et al., *Comment Letter on FHC Physical Commodities Activities* (Apr. 16, 2014) (link).

SIFMA, The American Bankers Association, Financial Services Forum, Financial Services Roundtable and Institute of International Bankers submitted this comment letter on the Federal Reserve's 2014 Advance Notice of Proposed Rulemaking. The Federal Reserve ignored the arguments laid out in this comment letter, in addition to 39 other letters supporting the view that the Federal Reserve should not curtail or eliminate the existing authority of FHCs to engage in physical commodities activities, out of 62 unique letters submitted by organizations, congressional representatives and law professors.

2. SCCL

Primary Sources

Federal Reserve, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies Proposed Rule* (Jan. 5, 2012) (link).
Federal Reserve, *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies* (Dec. 28, 2012) (link).

The Federal Reserve originally proposed its SCCL framework as a part of its EPS proposed rules for domestic banking organizations in December 2011 and for foreign banking organizations in December 2012. These proposals were deeply flawed and were never finalized as a result.

Federal Reserve, *Single-Counterparty Credit Limits for Large Banking Organizations Proposed Rule* (Mar. 16, 2016) (link).

The Federal Reserve originally reproposed its SCCL framework in March 2016.

Federal Reserve, *Calibrating the Single-Counterparty Credit Limit between Systemically Important Financial Institutions* (Mar. 4, 2016) (link).

The Federal Reserve released a white paper in conjunction with its 2016 reproposal to explain its rationale for a more stringent exposure limit on inter-G-SIB exposures. While it showed that G-SIB defaults were correlated with one another, it did not take into account in any meaningful way either the relative probability of a G-SIB default or the expected impact of such default, which is especially striking in light of the many regulatory reforms aimed specifically at addressing those very concerns.

Secondary Sources

Davis Polk & Warwell LLP, *Visual Memorandum on Single-Counterparty Credit Limits Proposed Rule* (Mar. 22, 2016) (link).

This visual memorandum summarizes the 2016 reproposal.

The Clearing House, American Bankers Association, The Financial Services Roundtable, SIFMA, International Swaps and Derivatives Association, *Comments in Response to the Notice of Proposed Rulemaking – Single Counterparty Credit Limits for Large Banking Organizations* (June 3, 2016) (link).

The comment letter submitted by SIFMA and other trade organizations on the 2016 re-proposal, arguing that the re-proposal, while an improvement over the original proposals, contains significant flaws and weaknesses that would make the SCCL framework needlessly difficult to operationalize and inaccurate in application.

3. Control

Primary Source(s)

Federal Reserve, Policy Statement on Equity Investments in Banks and Bank Holding Companies (Sept. 22, 2008) (link).

The Federal Reserve's 2008 policy statement that relaxed and clarified its long-standing control rules relating to minority investments in banks and bank holding companies with respect to expanded director rights, increased voting and total equity ceilings, permissible business relationships and veto rights.

Secondary Sources

Reena Agrawal Sahni, et al., *Control Under the Bank Holding Company Act*, in Regulation of Foreign Banks and Affiliates in the United States (Randall D. Guynn ed., 9th ed. 2016).

In this chapter, Reena Agrawal Sahni, a partner at the law firm Shearman & Sterling, and others provide a comprehensive review of control under the BHC Act, discussing the application of that concept to investments by FBOs in, and the activities and investments of, both U.S. banks and nonbanking companies.

Steven Davidoff Solomon, *In Blocking Activists, the Fed Protects Poorly Performing Banks*, N.Y. Times (May 8, 2012) (link).

This article is a story about the Federal Reserve injecting itself into a shareholder activist campaign by claiming that if a private equity firm that owned 9.8% of the bank filled the majority of director seats, as they had proposed to do in advance of the company's annual meeting, the private equity firm would become regulated as a bank holding company.

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I. Securitization

Primary Sources

U.S. Banking Agencies, *U.S. Basel III Final Rule* (Oct. 11, 2013) (link).

The U.S. Banking Agencies implemented the Basel III final rule for risk-based and leverage capital requirements.

Basel Committee, *Basel III: Revisions to the Securitisation Framework* (Dec. 11, 2014; revised July 2016) (link).

The Basel Committee published an updated the standard for the regulatory capital treatment of securitization exposures, providing amendments to the 2014 capital standard rules for securitizations.

U.S. Banking Agencies, *Liquidity Coverage Ratio Final Rule* (Oct. 10, 2014) (link).
The U.S. Banking Agencies implemented a quantitative liquidity requirement designed to strengthen the banking sector's ability to absorb shocks from economic stress and improve the management of liquidity risk.

Federal Reserve, *Capital Plan Final Rule* (Dec. 1, 2011) (link).
The Federal Reserve codified CCAR, requiring BHCs with total consolidated assets of $50 billion or more to submit annual capital plans to the Federal Reserve.

Federal Reserve, *2017 CCAR and Stress Test Scenarios* (Feb. 10, 2017) (link).
The Federal Reserve releases the baseline, adverse and severely adverse scenarios for the annual stress testing cycle each year.

SEC, *Asset-Backed Securities Disclosure and Registration Final Rule* (Sept. 24, 2014) (link).
The SEC established rules regarding Regulation AB and other rules governing offering process, disclosure, and reporting for asset-backed securities.

U.S. Banking Agencies, *Credit Risk Retention Final Rule* (Dec. 24, 2014) (link).
The U.S. Banking Agencies adopted a final rule to implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934, which requires the securitizer of asset-backed securities to retain not less than 5% of the credit risk of the assets collateralizing the asset-backed securities.

CFPB, *Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z) Final Rule* (Jan. 30, 2013) (link).
The final rule implements sections 1411 and 1412 of the Dodd-Frank Act, which generally require creditors to make a reasonable, good faith determination of a consumer's ability to repay any consumer credit transaction secured by a dwelling and establishes certain protections from liability under the requirement for QM.

CFPB, *Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z) Final Rule* (Dec. 31, 2013) (link).
CFPB implemented rules and forms to combine certain disclosures that consumers receive in connection with applying for and closing on a mortgage loan under the Truth in Lending Act and the Real Estates Settlement Procedures Act.

CFPB, *TILA-RESPA Integrated Disclosures, Part 1—Overview of the Rule* (June 17, 2014) (link).
The webinar provided a discussion on the TILA-RESPA Integrated Disclosure Rules.

CFPB, *TILA-RESPA Integrated Disclosure Rule Implementation Resource Guide* (last accessed Apr. 13, 2017) (link).

The guide provides resources to help market participants understand, implement, and comply with the Know Before You Owe mortgage disclosure rules.

Secondary Sources

Jason H.P. Kravitt, *Securitization of Financial Assets* (3d ed. 2012).

This seminal treatise on securitization law, edited by Jason Kravitt, a partner in the law firm Mayer Brown, discusses all aspects of the various laws and regulations that affect securitization, both in depth and with deep knowledge of market practice.

NERA Consulting, *Study of the Impact of Securitization on Consumers, Investors, Financial Institutions, and the Capital Markets* (June 17, 2009) (link).

The American Securitization Forum commissioned a NERA team to conduct a study to evaluate the impact of securitization. The study's findings suggest that securitization lowers the cost of consumer credit, reducing yield spreads across a range of products. Also, a reduction in securitization activity has a negative impact on lending activity.

Global Financial Markets Association et al., *Joint Associations' Response to the Second Consultative Document on Revisions to the Basel Securitisation Framework* (Mar. 24, 2014) (link).

Joint Association's letter to the *Revisions to the Basel Securitisation Framework* by the Basel Committee provided sector experts' views on the importance of well-tailored securitization rules to the economy.

SIFMA and Structured Finance Industry Group, *Comments to Federal Agencies on Liquidity Coverage Ratios Relating to Securitization* (Jan. 31, 2014) (link).

The Associations commented how LCR regulations should recognize that traditional securitization activities are an essential source of core funding to the real economy and an important part of a bank's liquidity management strategy.

SIFMA et al., *Comments to Bank Regulators on the Fundamental Review of the Trading Book* (Nov. 12, 2015) (link).

The Associations expressed concerns with the proposed capital requirements in the Fundamental Review of the Trading Book by the Basel Committee. The capital requirements are punitive to securitizations and other asset classes, threatening the liquidity and ability to fund credit creation in securitization markets.

SIFMA, *Comments to the SEC on Disclosure for Asset-Backed Securities* (Nov. 15, 2010) (link).

SIFMA provided observations and recommendations for the new proposed Rule 15Ga-1 including the scope and extent of the rule, and the clarification of definitions in the rule.

SIFMA, *Comments to the SEC on Shelf Eligibility Conditions for Asset-Backed Securities* (Oct. 4, 2011) (link).

SIFMA provided comments to the re-proposal of shelf eligibility conditions for asset-backed securities. SIFMA also provided recommendations that will make the markets for asset-backed securities and other structured finance products more transparent, more stable, and more efficient.

SIFMA and Financial Services Roundtable, *Comments to the SEC on Dissemination of Asset-Level Data* (Mar. 28, 2014) (link).

The Associations urged the SEC to abandon the flawed disclosure mechanism suggested in the staff memorandum. The flaw would expose both consumers and issuers to unwarranted risks and liabilities. The Associations urged the Commission to re-propose the asset-backed securities Releases to accommodate a more detailed and comprehensive reconsideration of the difficult technical, legal, and public policy concerns raised by asset-level disclosure.

SIFMA and Financial Services Roundtable, *Additional Comments to the SEC Regarding Dissemination of Asset-Level Data* (Apr. 28, 2014) (link).

SIFMA and the Financial Services Roundtable provided further comments to the SEC regarding the dissemination of Asset-Level Data. The comments suggest that issuers might use their websites to disseminate asset-level data and other offering information to investors and potential investors with respect to the disclosure and reporting requirements for asset-backed securities.

SIFMA, the Loan Syndications and Trading Association and Structured Finance Industry Group, *Comment Letter on Proposed Rule Concerning Risk Retention and the Implementation of the Dodd-Frank Act* (Jan. 10, 2014) (link).

The letter proposed a further alternative approach to implementing Section 941 that is designed to meet the objectives and concerns set forth in the agencies' orders while also avoiding the promulgation of rules that would otherwise dramatically reduce the scope and market role of Open Market CLOs.

SIFMA, *Comments to Multiple Federal Agencies on Joint Proposed Rules Relating to Credit Risk Retention* (April 21, 2011) (link).

SIFMA requested clarifications on the proposed rule relating to credit risk retention.

SIFMA et al., *Comments to Multiple Federal Agencies on Credit Risk Retention* (Oct. 30, 2013) (link).

SIFMA, American Bankers Association, the ABA Securities Association, and the Financial Services Roundtable provided comments on the proposed rule for credit risk retention.

SIFMA, *Supplemental Comments to Prudential Regulators and the CFTC on Margin Requirements for Securitization Swaps* (Nov. 24, 2014) (link).

SIFMA provided supplemental comments regarding a proposal that would require the daily exchange of variation margin for non-cleared swaps, including those entered into by securitization transactions.

SIFMA, *Comment Letter on Margin and Capital Requirements for Covered Swap Entities* (Nov. 24, 2014) (link).

SIFMA provided comments to multiple agencies regarding their proposals on margin requirements for uncleared swaps.

SIFMA, *Comment Letter on Margin and Capital Requirements for Covered Swap Entities* (Nov. 24, 2014) (link).

SIFMA's Asset Management Group provided comments to multiple agencies regarding their proposals on margin requirements for uncleared swaps.

SIFMA, *Comments to the Federal Reserve on Proposed Changes to Regulation Z and the Definition of Qualified Mortgage* (July 22, 2011) (link).

SIFMA offered recommendations and observations on the proposals relating to amendments to Regulation Z that would implement changes to TILA by the Dodd-Frank Act. In particular, SIFMA noted the importance of this rulemaking, in particular the incorporated definition of QM. SIFMA also offered recommendations, focusing on the application of the QM to secondary markets.

SIFMA, *Comments to the CFPB on Qualified Mortgage Regulation* (Apr. 30, 2012) (link).

SIFMA addressed three points related to QM regulation: (1) the parameters of the QM definition must be scaled broadly. (2) due to the risk of liability inherent in non-QM lending, the parameters of the definition must provide clear, bright lines, and a safe harbor for compliance; and (3) the need for further, more detailed discussion of these issues with secondary market participants.

Kenneth E. Bentsen Jr., *House Financial Services Subcommittee Testimony on the Impact of Dodd-Frank's Home Mortgage Reforms* (July 12, 2012) (link).

Kenneth E. Bentsen Jr., Executive Vice President of SIFMA, testified that the vast majority of future mortgage lending was likely to comport with the guidelines established by the QM definition. SIFMA is very concerned that the QM regulations may be constructed in a narrow manner with parameters that will not allow for the certainty of compliance at origination.

SIFMA, *Comments to Multiple Federal Regulators on the Application of the Volcker Rule to Securitization and Insurance-Linked Securities Transactions* (Feb. 13, 2012) (link).

SIFMA provided comments regarding the Volcker Rule related to the proposed rules that affect the treatment of asset-backed securities.

SIFMA, *Supplemental Comments to Multiple Federal Regulators on the Volcker Rule and Securitization* (May 21, 2012) (link).

SIFMA's letter suggested revisions to the covered fund definition regarding asset-backed securities and others.

Mortgage Bankers Association, *Letter to CFPB Regarding TRID Cure Guidance* (Dec. 21, 2015) (link).

Mortgage Bankers Association expressed concerns over lingering misperceptions and technical ambiguities in the regulations. The letter also sought a commitment from CFPB to substantively re-engage with industry to provide a process for ongoing written regulatory clarifications during the "diagnostic period."

Richard Cordray, *CFPB Response to MBA TRID Letter* (Dec. 29, 2015) (link).

The letter stated that CFPB would work to ensure that implementation of the rule will not disrupt the secondary market. The letter also provided that rejection based on minor errors would be an overreaction to the initial implement of the new rule. The letter also stated that risk of private liability to investors is negligible for good-faith formatting errors and the like.

SIFMA, *Comments to US Treasury Department on Development of Responsible Private Label Securities Market* (Aug. 8, 2014) (link).

SIFMA provided comments to the U.S. Treasury Department's consultation regarding the development of a functioning private-label securities (PLS) market. SIFMA believes that the recovery of private-sector securitization is necessary to support the economy's needs.

Jamie Dimon, *Chair and CEO Letter to Shareholders* (Apr. 4, 2017) (link).

In April 2017, Jamie Dimon published his Annual Letter to Shareholders. Particularly, the letter addressed the need to promote return of private capital.

John Walsh, *Senate Banking Committee Testimony on the implementation of the Dodd-Frank Act* (July 21, 2011) (link).

John Walsh, who was the Acting Comptroller of the Currency in 2011, testified before the U.S. Senate regarding the impact of the financial crisis and the implementation of the Dodd-Frank Act. Walsh recognized the importance of securitization markets as an important source of credit to U.S. households, businesses, and governments.

Thomas Curry, *Senate Banking Committee Testimony on the implementation of the Dodd-Frank Act* (Feb. 14, 2013) (link).

Thomas Curry, the Comptroller of the Currency, testified before the Senate regarding the implementation of the Dodd-Frank Act. Curry also recognized and reiterated the importance of securitization markets as an important source of credit.

SIFMA, *US ABS Issuance and Outstanding* (Apr. 6, 2017) (link).

SIFMA publishes asset-backed securities data on issuance and outstanding.

SIFMA, *US Mortgage-Related Issuance and Outstanding* (Apr. 6, 2017) (link).

SIFMA publishes data on mortgage-related issuance and outstanding, including agency mortgage-backed securities and non-agency mortgage-backed securities.

Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit* (Feb. 2017) (link).

The Federal Reserve Bank of New York publishes a quarterly report on household debt and credit. In 2016 Q4, total household indebtedness was $12.58 trillion.

The World Bank, *GDP (Current US$)* (Mar. 23, 2017) (link).

The World Bank publishes GDP by country. In 2015, the U.S. GDP was $18.04 trillion in 2017 dollars.

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J. Promoting Equity Market Issuance

Primary Sources

JOBS Act, Pub. L. No. 112-106 (2012) (link).

The Jumpstart Our Business Startups (JOBS) Act of 2012 amended the Securities Act and the Securities Exchange Act in a number of ways to facilitate capital formation. It created a new category of issuer—emerging growth companies—that is permitted to "test the waters" by gauging interest in an IPO without those communications being considered offers in violation of the securities laws. The JOBS Act also lightened certain disclosure requirements for emerging growth companies and eliminated the prohibition of general solicitation in connection with private placements to accredited investors.

Section 404 of the Sarbanes-Oxley Act (link).

Section 404 of the Sarbanes-Oxley Act requires issuers of public securities to establish, maintain and regularly assess internal controls and procedures for financial reporting.

Section 2(a)48 of the Investment Company Act of 1940 (link).

Section 2(a)(48) of the Investment Company Act defines "business development companies", a category of company designed to facilitate capital formation for small and middle-market companies that are exempt from many of the regulatory constraints imposed by the Investment Company Act on investment companies.

Regulation D under the Securities Act of 1933 (link).

Regulation D is an SEC regulation under the Securities Act that provides certain safe harbor exemptions to registration requirements for private placements of securities to accredited investors.

Rules 501 (link) and 506 (link) under the Securities Act of 1933.

Rules 501 and 506 are rules in Regulation D that define "accredited investor" and provide a safe harbor exemption from SEC registration requirements for private placements of securities to accredited investors, respectively.

Rule 144 under the Securities Act of 1933 (link).

Rule 144 is an SEC rule under the Securities Act permitting resales into the public markets of securities originally purchased in a private placement.

Rule 139 under the Securities Act of 1933 (link).

Rule 139 is an SEC safe harbor under the Securities Act allowing broker-dealers participating in securities distributions to publish research reports under certain conditions without those communications being considered offers in violation of the securities laws.

S.828, 115th Congress (2017) (link).

S.828 is a Senate bill sponsored by Senator Rounds [R-SD] that would amend the Federal Deposit insurance Act to require federal banking agencies to treat municipal obligations as HQLA that is a Level 2B asset if they are liquid, readily-marketable and investment grade.

Financial CHOICE Act of 2017, Title IV Subtitle V. Section 499 (link) and Title VIII, Subtitle B. Section 847 (link) (Apr. 26, 2017).

The Financial CHOICE Act would extend to all issuers the JOBS Act's provisions for testing the waters and confidential submission of the registration statement before an IPO. It would also increase the threshold for compliance with Sarbanes-Oxley internal control evaluations to $500 million market capitalization or $1 billion in assets for banks.

Secondary Sources

Edward F. Greene et al., *U.S. Regulation of the International Securities and Derivatives Markets* (Dec. 2014).

This book by Edward F. Greene, a partner of the law firm Cleary Gottlieb Steen & Hamilton, is the foremost and most comprehensive guide to the complex U.S. regulation of the global securities and derivatives markets.

Michael S. Piwowar, *New Special Study of the Securities Markets: Keynote Address* (Mar. 23, 2017) (link).

Acting SEC Chair Michael S. Piwowar gave this Keynote Address to kick off a new project in Columbia University's Program in the Law and Economics of Capital Markets. The project, the New Special Study of the Securities Markets, undertakes an independent, in-depth analysis of the current state of U.S. securities regulation intended to inform and enhance the quality of financial market regulatory reform.

Committee on Capital Markets Regulation, *U.S. Public Equity Markets Are Stagnating* (Apr. 17, 2017) (link).

This study demonstrates quantitatively that the U.S. IPO markets are stagnating, as evidenced by lower volumes of equity capital raised in IPOs and lower numbers of IPOs per year in the 2006-2016 period relative to the 10-year historical average for the 1996-2016 period, as well as a consistently declining number of U.S. listings since 1996. The study argues that the result is that fewer small businesses are funded and formed, creating a drag on economic growth. The Committee believes that this stagnation can be partly explained by the high costs of securities regulation and the risk of securities class actions.

U.S. Chamber of Commerce, *Restarting the Growth Engine: A Plan to Reform America's Capital Markets* (Sept. 12, 2016) (link).

This plan published by the Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce set forth recommendations for regulatory reform in a wide range of areas impacting the U.S. capital markets. Among other recommendations, the plan recommends building on the positive impact of the JOBS Act to increase small business access to capital by passing a JOBS Act 2.0 package.

Credit Suisse Global Financial Strategies, *The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer U.S. Equities* (Mar. 22, 2017) (link).

This study by Credit Suisse demonstrates that IPOs and public listings of securities have fallen sharply since 1996 while M&A activity has flourished over the same period.

IPO Task Force, *Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth* (Oct. 2011).

In March 2011, the U.S. Treasury Department convened the Access to Capital Conference to "gather insights from capital markets participants and solicit recommendations for how to restore access to capital for emerging companies – especially public capital through the IPO market." The Task Force, a group of private sector professionals, examined the challenges that emerging growth companies face in pursuing IPOs and published this Report providing recommendations for restoring effective access to the public markets.

Craig Doidge, G. Andrew Krolyi & René Stulz, *The U.S. Listing Gap* (Fisher College of Business Working Paper No. 2015-03-07, May 13, 2015) (link).

This article by professors from the University of Toronto, Cornell University and The Ohio State University demonstrates that the United States has abnormally few listed firms compared to other countries and argues that this listing gap correlates with a decrease in the net benefit of a listing for U.S. firms.

The National Bureau of Economic Research, *Why Are There So Few Public Companies in the U.S.?* (Sept. 28, 2015) (link).

This article summarizes the findings of professors Doidge, Karolyi and Stulz on the declining numbers of U.S. listings and highlights the fact that the total number of listed companies in the United States fell from 8,000 to 4,100 from 1996 to 2012, while the rest of the world saw an increase from 30,700 to 39,400.

Thomas Quaadman, *House Financial Services Committee Testimony on the JOBS Act's Impact* (Mar. 22, 2017) (link).

In his testimony to the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment, Thomas Quaadman, the Executive Vice President of the Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce, examines the positive impact of the JOBS Act and discusses regulatory reforms necessary to ensure the competitiveness of the U.S. capital markets. Mr. Quaadman testifies that the long-term decline in the number of public companies in the United States is a tragic outcome for the U.S. economy and urges Congress to consider expanding the regulatory accommodations afforded to emerging growth companies by the JOBS Act in a manner that does not compromise transparency and investor protection.

Edward S. Knight, *House Financial Services Committee Testimony on the JOBS Act's Impact* (Mar. 22, 2017) (link).

In his testimony to the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment, Edward Knight, General Counsel and Chief Regulatory Officer of Nasdaq, testifies that while the JOBS Act was a success in improving access to the capital markets, the job is not over. Among other recommended reforms, the testimony supports allowing all companies to be allowed to file IPO registration statements with the SEC on a confidential basis and extending testing the waters flexibility to all companies.

SIFMA, *Letter to Senate Banking Committee Responding to Request for Proposals* (Apr. 13, 2017).

This letter to Senators Mike Crapo and Sherrod Brown, Chair and Ranking Member, respectively, of the Senate Committee on Banking, Housing, and Urban Affairs, discussed SIFMA's belief that there are many opportunities to enhance capital formation that will reduce regulatory burdens and support entrepreneurs while maintaining protections for investors. The letter urges Congress to reassess securities regulations to allow more businesses to access U.S. capital markets and sets forth a number of specific recommendations for statutory and regulatory amendments consistent with such increased market access.

Michael S. Piwowar, *Remarks at the "SEC Speaks" Conference 2017; Remember the Forgotten Investor* (Feb. 24, 2017) (link).

In this speech, Piwowar discussed the need to amend the definition of "accredited investor" to allow more investors to benefit from a more diversified portfolio of investments in terms of risk and return.

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K. Enhanced Prudential Standards for Foreign Banking Organizations

Primary Sources

Federal Reserve, *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banks and Financial Companies Proposed Rule* (Dec. 28, 2012) (link).

The Federal Reserve proposed a tiered approach for applying U.S. capital, liquidity and other Dodd-Frank Act enhanced prudential standards, including single counterparty credit limits, risk management, stress testing and early remediation requirements, to the U.S. operations of foreign banking organizations with total global consolidated assets of $50 billion or more.

Federal Reserve, *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banks and Financial Companies Final Rule* (Mar. 27, 2014) (link).

The final rule establishes a number of enhanced prudential standards, including liquidity, risk management and capital. It also requires a foreign banking organization with a significant U.S. presence to establish an IHC over its U.S. subsidiaries, to facilitate supervision and regulation of the U.S. operations of the foreign banking organization.

European Commission, *Proposal to Amend Directive of the European Parliament* (Nov. 23, 2016) (link).

This 2016 proposal amends Directive 2013/36/EU in regards to exempted entities, FHCs, mixed FHCs, remuneration, supervisory measures and powers and capital conservation measures.

Secondary Sources

Luigi L. De Ghenghi, *The IHC Requirement and Enhanced Prudential Standards for FBOs*, in Regulation of Foreign Banks and Affiliates in the United States (Randall D. Guynn ed., 9th ed. 2016).

This treatise provides a comprehensive overview of the regulatory regime applicable to foreign banking organizations in the United States. This chapter specifically focuses on enhanced prudential standards.

John L. Thornton et al., *Comment Letter on Proposal for a Directive regarding Exempted Entities, Financial Holding Companies, Mixed Financial Holding Companies, Remuneration, Supervisory Measures and Powers and Capital Conservation Measures* (Jan. 6, 2017) (link).

In this comment letter, the Committee on Capital Markets Regulation expresses concern with the European Commission's proposed EU IHC requirement and identifies ways in which national ring-fencing threatens to undermine financial stability.

R. Glenn Hubbard et al., *Comment Letter on Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations, Proposed Rule* (Apr. 24, 2013) (link).

This comment letter addresses concerns that the U.S. IHC requirement may undermine U.S. financial stability, impede economic growth and provoke non-U.S. regulators to adopt retaliatory ring-fencing measures of their own.

Michel Barnier, *Letter to Ben Bernanke* (Apr. 18, 2013) (link).

In this letter, Michel Barnier, then European Commissioner for Internal Market and Services, raised objections to the U.S. IHC requirement, which he noted risks triggering protectionist responses from other jurisdictions.

The Clearing House et al., *Comment Letter on Implementation of Dodd-Frank Act Sections 165 and 166 for Foreign Banks and Financial Companies* (Apr. 30, 2013) (link).

In this comment letter, a coalition of industry groups identified several flaws with the proposed U.S. IHC requirement, including that the proposed U.S. IHC requirement was inconsistent with international regulatory cooperation and coordination, that national ring-fencing threatened financial stability and market competitiveness and that the U.S. IHC requirement was inconsistent with the Dodd-Frank Act.

Michael Barr, Howell E. Jackson and Margaret E. Tahyar, *Financial Regulation: Law and Policy* (2016).

Chapter 6.3 of this casebook, “Foreign Banks in the United State and U.S. Banks Abroad,” provides a succinct overview of U.S. regulation of foreign banking organizations and the international activities of U.S. banking organizations.

Davis Polk & Wardwell LLP, *Visual Memorandum on U.S. Intermediate Holding Company Structuring and Regulatory Considerations for Foreign Banks* (Apr. 2, 2014) (link).

This visual memorandum describes the U.S. IHC requirement and identifies key regulatory implications (including with respect to capital and liquidity) of forming a U.S. IHC.

Davis Polk & Wardwell LLP, *Visual Memorandum on Dodd-Frank Enhanced Prudential Standards Final Rule for Foreign Banks* (Feb. 24, 2014) (link).

This visual memorandum provides an overview of key aspects of the Dodd-Frank enhanced prudential standards final rule that apply to foreign banking organizations with $50 billion or more in total global consolidated assets.

Davis Polk & Wardwell LLP, *Visual Memorandum on Dodd-Frank Enhanced Prudential Standards Final Rule for Foreign Banks with Limited U.S. Footprints* (Mar. 24, 2014) (link).

This visual memorandum provides an overview of key aspects of the Dodd-Frank enhanced prudential standards final rule that apply to foreign banking organizations with $50 billion or more in global assets but less than $50 billion in combined U.S. assets, as well as to foreign banking organizations with more than $10 billion but less than $50 billion in global assets.

Davis Polk & Wardwell LLP, *Visual Memorandum and Interactive Calculator for Foreign Banks: U.S. Liquidity Buffer Requirement* (Feb. 27, 2014) (link).

This visual memorandum describes how, pursuant to the Dodd-Frank enhanced prudential standards final rule, foreign banking organizations with $50 billion or more are required to calculate U.S. liquidity buffers for their U.S. branches/agencies and U.S. IHCs.

Daniel K. Tarullo, *Departing Thoughts* (Apr. 4, 2017) (link).

In this speech, Tarullo offers a broad perspective on how financial regulation changed after the financial crisis and related thoughts.

Daniel K. Tarullo, *Regulating Large Foreign Banking Organizations* (Mar. 27, 2014) (link).

In this speech, Tarullo defends the U.S. IHC requirement as necessary to apply U.S. capital standards to the U.S. operations of foreign banking organizations.

Bank of England, *The Financial Policy Committee's Review of the Leverage Ratio* (Oct. 1, 2014) (link).

This review contains proposals for the design of the leverage ratio framework, including views on the calibration of that framework.

Bank of England, *Supervisory Statement on the UK Leverage Ratio Framework* (Dec. 7, 2015) (link).

"This supervisory statement is aimed at Capital Requirements Regulation firms in scope of the UK leverage ratio framework. The purpose of this SS is to set out the expectations of the Prudential Regulatory Authority on leverage ratio buffers and the reporting and disclosure of an averaged leverage ratio, as well as to provide some clarification on the PRA rules."

Bank of England, *Policy Statement on Implementing a UK Leverage Ratio Framework* (Dec. 7, 2015) (link).

"This policy statement provides feedback to responses to the Consultation Paper (CP) 24/15: 'Implementing a UK leverage ratio framework.' It sets out the changes made to the rules and supervisory statements proposed in the CP."

Bank of England, *Financial Policy Committee Statement and Record from Its Policy Meeting* (Aug 4, 2016) (link).

This includes the Financial Policy Committee statement and record from its policy meeting held on July 25, 2016.

Bank of England, *Consultation Paper on Implementing a UK Leverage Ratio Framework* (July 10, 2015) (link).

This consultation paper "sets out how the [Prudential Regulation Authority] proposes to implement the Financial Policy Committee's (FPC) Direction and Recommendation on a UK leverage ratio framework."

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L. DOL Fiduciary Rule

Primary Sources

DOL, *Final Fiduciary Duty Rule* (Apr. 8, 2016) (link).
This final rule published by the DOL stemmed from the 2015 re-proposal. The rule broadly defines who is a fiduciary by reason of giving investment advice.

DOL, *Final Fiduciary Duty Rule* (Apr. 7, 2017) (link).
This final rule published by the DOL followed the President's Memorandum directing it to examine the rule which extends the original applicability date (April 10, 2017) by 60 days to June 9, 2017.

DOL, *Best Interest Contract Exemption with Amended Applicability Dates* (Apr. 7. 2017) (link).
This exemption is one of three exemptions to the final rule which permits firms to use certain current compensation models as long as they acknowledge their fiduciary status, give prudent and impartial advice, disclose potential conflicts of interest and information about their revenue model, avoid misleading statements, and receive reasonable compensation for their services.

White House, *Presidential Memorandum on Fiduciary Duty Rule* (Feb. 3, 2017) (link).
This Memorandum by the President directed the Secretary of Labor to examine the fiduciary rule and determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice. The Memorandum further states that the Secretary makes an affirmative determination that the rule does adversely affect the ability of Americans to gain access to retirement information and financial advice then the Secretary should either rescind or revise the rule as appropriate and consistent with law.

Secondary Sources

U.S. Chamber of Commerce, *Comment Letter on the Fiduciary Rule* (Apr. 17, 2017) (link).
This comment letter from the U.S. Chamber of Commerce discusses why the fiduciary rule is making it harder for retirement investors and the liability risks involved in the rule.

Davis Polk & Wardwell LLP, *Visual Memorandum on the Impact of the DOL Fiduciary Regulation* (June 3, 2016) (link).
This client memorandum provides a visual overview of the changes to previous DOL fiduciary regulations and discusses key aspects of the new regulation.

Financial Planning Coalition, *Comment Letter on the Fiduciary Rule* (Apr. 24, 2017) (link).
This comment letter from the Financial Planning Coalition discusses why the fiduciary rule is the best way forward in order to strengthen retirement security.

Appendix B – Sources for Figures

Figure 1: SNL Financial, Regulatory Filings. Prepared by Davis Polk & Wardwell LLP. All capital ratios presented on an aggregate (weighted average) basis for all eight U.S. GSIBs. Actual T1 Common as of 12/31/2008 reflects the Tier 1 Common ratio in effect before Basel III.

Figure 2: SNL Financial, Regulatory Filings. Prepared by Davis Polk & Wardwell LLP. Data from BAC, BNYM, C, JPM, STT and WFC. Liquid Assets = Cash and Due from Banks + non-trading U.S. Treasury, Agencies and GSE Debt; Deposits = Deposits Excluding Time Deposits; and Total Liabilities = Total Liabilities (excluding minority interests).

Figure 3: SNL Financial, Regulatory Filings, Federal Reserve Bank of New York. Prepared by Davis Polk & Wardwell LLP. Short-term funding defined as commercial paper, trading liabilities, <1 year borrowings, repurchase agreements. Ratio shown as aggregate of all U.S. G-SIBs.

Figure 4: Adam Copeland, Isaac Davis & Ira Selig, *What's Your WAM? Taking Stock of Dealers' Funding Durability* (June 9, 2014) (link).

Figure 5: Federal Reserve, SNL Financial, regulatory filings. Prepared by Davis Polk & Wardwell LLP. All capital ratios presented on an aggregate (weighted average) basis. Ratios for 2008 exclude MS and GS because information on the other TLAC components is not publicly available. Ratios for 2016 include all eight U.S. G-SIBs.

Figure 6: Steve Strongin, Sandra Lawson, Sonya Banerjee & Katherine Maxwell, *The Two-Speed Economy Still Runs on Two Tracks* (Mar. 2017) (link).

Figure 7: Steve Strongin, Sandra Lawson, Sonya Banerjee & Katherine Maxwell, *The Two-Speed Economy Still Runs on Two Tracks* (Mar. 2017) (link).

Figure 8: The Clearing House, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test* (Jan. 2017) (link).

Figure 9: Credit Suisse Global Financial Strategies, *The Incredible Shrinking Universe of Stocks* (Mar. 22, 2017) (link).

Figure 10: ISDA, *SwapsInfo Weekly Analysis* (Apr. 7, 2017) (link).

Figure 11: CFTC, *Letters Archive* (link).

Figure 12: Dealogic (last accessed Apr. 5, 2017). Includes SEC Registered IPOs > $25 million. Excludes BDCs, SPACs, MLPs, CLEFs, REITs.

Figure 13: Dealogic (last accessed Apr. 5, 2017). Includes SEC Registered IPOs > $25 million. Excludes BDCs, SPACs, MLPs, CLEFs, REITs.

Figure 14: Dealogic (last accessed Apr. 5, 2017). Excludes REITs, CLEFs, SPACs, BDCs, MLPs, non US domiciled companies, and offerings < $25 million.

Figure 15: Dealogic (last accessed Apr. 5, 2017). Excludes SPACs, REITs, BDCs, MLPs. **US**: U.S. Listed SEC Registered IPOs > $25 million. Excludes BDCs, SPACs, MLPs, CLEFs, REITs. Shaded portion in 2014 represents Alibaba IPO ($25 billion). **China**: Chinese listed IPOs > $25 million. Excludes BDCs, SPACs, MLPs, CLEFs, REITs.

Figure 16: FSOC, Annual Report 77 (2016) (link).