Coalition for Derivatives End-Users

October 17, 2018

Board of Governors of the Federal Reserve System
Attn: Ann E. Misback, Secretary
20th Street and Constitution Avenue, NW
Washington, DC 20551

Commodity Futures Trading Commission
Attn: Christopher Kirkpatrick, Secretary
1155 21st Street, NW
Washington, DC 20581

Office of the Comptroller of the Currency
Attn: Legislative and Regulatory Activities Division
400 7th Street, SW, Suite 3E-218
Washington, DC 20219

Securities and Exchange Commission
Attn: Brent J. Fields, Secretary
100 F Street, NE
Washington, DC 20549-1090

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
Attn: Comments/Legal ESS
550 17th Street, NW
Washington, DC 20429

Re: End-User Support for Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds [Federal Reserve: Docket No. R-1608; RIN 7100-AF 06] [OCC: Docket ID OCC-2018-0010] [FDIC: RIN 3064-AE67] [CFTC: RIN 3038-AE72] [SEC: File Number S7-14-18]

The Coalition for Derivatives End-Users (the "Coalition") appreciates the opportunity to provide comments in response to the *Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (the "Proposed Rule")[1] issued by the Board of Governors of the Federal Reserve System ("Federal Reserve"), Office of the Comptroller of the Currency ("OCC"), Federal Deposit Insurance Corporation ("FDIC"), Commodity Futures Trading Commission ("CFTC"), and Securities and Exchange Commission ("SEC", together with the Federal Reserve, OCC, FDIC, and CFTC, the "Agencies").

The Coalition supports the Proposed Rule and believes that reforms to the Volcker Rule will help end-users continue to serve as economic engines in the United States. While commercial end-users do not have any direct obligations under the Volcker Rule, we believe that the rule's existing regulatory burdens affecting end-users' bank counterparties and intermediaries have had negative effects on market liquidity and end-users' access to capital. The Coalition respectfully requests that any proposed reforms to the Volcker Rule address these deleterious effects.

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[1] Proposed Rule, *Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 83 Fed. Reg. 33432 (July 17, 2018) *available at* https://www.federalregister.gov/documents/2018/07/17/2018-13502/proposed-revisions-to-prohibitions-and-restrictions-on-proprietary-trading-and-certain-interests-in [hereinafter, the "Proposed Rule"].

In the sections that follow, we: (A) provide background on the Coalition; and (B) express our views regarding the current rule's direct impact on market liquidity and economic costs and how those impacts and costs have indirectly affected end-users.

A. Background on the Coalition

The Coalition represents the views of end-users and trade groups that constitute or otherwise represent a range of commercial U.S. businesses across a host of sectors from manufacturing to healthcare to agriculture to energy to technology.[2] Our members are the engines of the U.S. economy and they use derivatives in order to provide more stable prices to U.S. consumers.

The Coalition supports strong, effective and fair regulation of derivatives markets, which appropriately balances the goals of promoting transparency and mitigating systemic risk against the risks of unduly burdening American businesses and harming job growth. The Coalition strongly believes that any financial regulatory reform measure that restricts access to capital or imposes significant direct or indirect costs on end-users—parties that did not contribute to the 2008 financial crisis—without proper justification, risk mitigation or increased transparency runs contrary to an effective regulatory regime.

The Coalition has not previously commented on the Volcker Rule. Following the rule's implementation, however, we have been and are concerned by an apparent reduction in the availability of certain bespoke and less liquid derivatives products, which has resulted in our members having to pay additional transaction costs when entering into those products. In addition, we understand that some of our members have experienced difficultly accessing capital since their bank underwriters have reduced their underwriting activities, especially in situations where such banks are unable to immediately offset all of their underwriting risks in secondary capital markets. These market impacts and the potential for future impacts are the reasons why the Coalition is providing these comments at this time.

B. The Coalition's Views on the Current Rule

The Coalition applauds the Agencies' efforts to propose revisions to their respective implementing regulations promulgated under Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (together with the implementing regulations, the "Volcker Rule").[3] We fully agree with the objectives underlying the Agencies' efforts to "simplify and tailor the implementing regulations [of the Volcker Rule] . . . in order to increase efficiency, reduce excess demands on available compliance capacities at banking entities, and allow banking entities to more efficiently provide services to clients."[4] The Coalition also commends the Agencies' coordinated and unified approach in jointly adopting the Proposed Rule (with one synchronized comment period) in order "to avoid unnecessary

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[2] You can see a list of companies and associations that have been active in the Coalition here: http://coalitionforderivativesendusers.com/AboutUs/coalition-members.

[3] 12 U.S.C. § 1851.

[4] Proposed Rule at 33435.

duplication of oversight, reduc[e] costs for banking entities, and provid[e] for more efficient regulation."[5]

The Coalition appreciates the Agencies' acknowledgement that regulatory implementation of the Volcker Rule requires adjustments to reflect the economic realities and costs associated with the current regulatory regime. We are supportive of these efforts, as the end-user community faces increased costs and risks as a result of this rule. In particular, the Volcker Rule has impacted Coalition members because (a) the Volcker Rule's "Reasonably Expected Near Term Demand" ("RENTD") standard is demonstrably too complex for banking entities to comply with, which has increased costs and risks for these banking entities, and (b) commercial end-users do business with these banking entities either as counterparties or intermediaries and the increased costs and risks are passed along to end-users. Each point is explained in detail below.

a. The Volcker Rule's "Reasonably Expected Near Term Demand" Standard is Demonstrably Too Complex

The Volcker Rule generally prohibits covered banking entities from engaging in proprietary trading and from owning or controlling hedge funds or private equity funds. The rule establishes several complex exemptions from the proprietary trading prohibition for certain qualifying activities, including market making and underwriting activities. These exemptions, however, require banking entities to, among other things, evaluate whether their proposed activity will satisfy the RENTD standard.[6] This standard requires the covered banking entity to estimate future customer demand (based largely on past bank activity), while also accounting for other factors such as the banking entity's risk appetite. After estimating demand and accounting for a host of other factors, the covered banking entity is then required to establish risk and position limits on their market-making inventory, level of exposures to relevant risks arising from underwriting positions, hedges, exposures and holding periods.

To highlight the difficulty in applying the RENTD standard to a commercial end-user's hedging transaction, we offer the following example. A manufacturing company, recognized as the low-cost producer and leading market provider, now looks to expand its production capacity. Due to its market position and size, it expects to make a positive cash-flow even at cyclical lows for the commodity's price variability. However, the risk inherent in the variability of its net cash-flows reduces the risk-adjusted profitability of the project over its expected life and raises the overall financing cost. With its access to the commodity derivatives markets, the manufacturer would typically structure a long-term commodity swap that mitigates much of the variability in the commodity's price swings. In light of RENTD requirements, however, a bank counterparty must first estimate future demand for this swap and its own ability to off-set and sell this obligation to another counterparty. In instances where the manufacturing company is the predominant or sole producer of a commodity, a bank may have difficulty meeting the

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[5] Proposed Rule at 33436.

[6] The purpose of establishing risk and position limits is to monitor, identify, escalate and remediate any trading activity that may constitute impermissible proprietary trading. *See* Proposed Rule at 33452. Banking entities also must provide evidence to regulators that they have escalated and remediated any breaches in a timely basis.

RENTD standard for a long-dated product in a niche commodity market. Consequently, the remaining bank counterparties that continue to deal in these niche markets either have to decline entering into the transaction altogether or will likely offer pricing on the long-dated product with such terms where the economics for the manufacturer becomes impracticable.

As a result of RENTD, it is our understanding that banks dealing with end-users are forced into a situation of having to choose between (i) entering into a transaction and risking regulatory scrutiny or penalties for RENTD non-compliance or (ii) erring on the side of caution by foregoing an otherwise legitimate and permissible transaction. If banks elect the former, they are forced to run the proposed transactions through an enhanced compliance regime that increases costs for themselves as well as increases transaction costs and pricing for the product. Moreover, compliance costs may become cost-prohibitive and force a bank out of the market altogether. Similarly, if banks elect the latter, the market suffers from a loss in liquidity. Under either scenario, we believe that the interpretive uncertainty surrounding the RENTD standard may be having deleterious effects on the ability of end-users to efficiently manage and hedge their commercial risks.

Establishing a compliance program for the RENTD standard is extremely challenging for banking entities due to the lack of interpretive clarity around what types of qualifying activities will meet the standard.[7] We believe the lack of interpretive clarity has contributed to decreased market-making activities of end-users' bank counterparties and decreased underwriting activities of end-users' bank counterparties.[8] As now recognized by the Agencies, "[d]etermining whether or not positions fall into the short-term intent prong of the trading account definition has often proved unclear and subjective and, consequently, may result in ambiguity or added costs and delays."[9]

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[7] As Fed Vice Chair Quarles remarked in March 2018, banks should "be able to engage in market making and provide liquidity to financial markets with less fasting and prayer about their compliance with" the RENTD requirement. Speech, Vice Chairman for Supervision Randal K. Quarles, *The Federal Reserve's Regulatory Agenda for Foreign Banking Organizations: What Lies Ahead for Enhanced Prudential Standards and the Volcker Rule*, Institute of International Bankers Annual Washington Conference (Mar. 5, 2018) *available at* https://www.federalreserve.gov/newsevents/speech/quarles20180305a.htm. In addition to regulatory clarity, enforcement action on this point has yet to describe or detail the specific deficiencies, leaving market participants without appropriate guidance in which to benchmark their compliance regimes. *See, e.g.,* Consent Order, *In re Deutsche Bank AG*, Federal Reserve, Docket Nos. 17-009-B-FB / 12-009-CMP-FB (Apr. 20, 2017) ("Significant weaknesses existed in Deutsche Bank's demonstrable analyses showing that its proprietary trading is not to exceed the reasonably expected near term demands of clients, customers, or counterparties, required for permitted market-making activities, and Deutsche Bank did not subject trading desks' RENT-D methodologies to sufficient review or challenge by internal control groups.").

[8] Indeed, these concerns were first raised by market participants and academics at the time of the Volcker Rule's adoption. *See, e.g.*, Darrell Duffie, *Market Making Under the Proposed Volcker Rule*, Stan. Univ. Working Paper (Jan. 16, 2012) *available at* https://www.darrellduffie.com/uploads/policy/DuffieVolckerRule.pdf ([A] bank that continues to offer substantial market making capacity to its clients would face a risk of regulatory sanction (and the attendant stigma) due to significant and unpredictable time variation in the proposed metrics for risk and for profit associated with changes in market prices. . . Consequently, some banks may wish to exit the market making business) [hereinafter, "Duffie"].

[9] *Id*. at 33438.

For these reasons, we applaud the Agencies' current recognition for the need to "improve the practical application of these [underwriting] exemptions. . . [and] provide banking entities with more flexibility and certainty in conducting permissible underwriting and market making-related activities."[10] The Proposed Rule seeks to amend the current rule by allowing banking entities to use their own internal risk limits in order to satisfy the RENTD standard. The Coalition supports this approach since it will provide some flexibility. The Coalition respectfully requests that the Agencies consider providing banking entities with an express exemption to "transact at the request of a client", at a minimum when that client is a commercial end user.[11]

Absent meaningful change, like those recommended in the Proposed Rule and referred to above, banking entities will likely continue to face substantial legal and financial burdens associated with compliance with the Volcker Rule that will lead to downstream impacts on end-users. For example, as noted by several market participants and industry groups in their comments to the OCC's 2017 notice and request for comment on whether the Volcker Rule is achieving its statutory purposes:[12]

- "[The Volcker Rule] has created regulatory uncertainty, compliance costs, and a significant amount of compliance risk given the lack of clear, objective, and consistent standards regarding activities the Agencies believe constitute impermissible proprietary trading . . . Some institutions have been expected to have dedicated offices, committees, or teams focused entirely on Volcker."[13]

- "Volcker has resulted in an unwarranted compliance burden, which has caused thousands of job losses."[14]

- "[T]he Volcker Rule compliance program requirements have resulted in substantial compliance costs and uncertainty for banking entities . . . . The current rule forces banking entities to create

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10 *Id*.

11 We would envision that such an exemption would address those transactions that commercial end users rely on banking entities for but which do not neatly fit into the regulatory boxes of "market making" or "underwriting" or "risk mitigating hedging". An express acknowledgment and provision of regulatory relief could significantly help Coalition members.

12 OCC, *Public Comments in Response to OCC Notice Seeking Input on the Volcker Rule: Detailed Summary of Key Issues and Recommendations* (2017) *available at* https://occ.gov/topics/capital-markets/financial-markets/trading-volcker-rule/volcker-notice-comment-summary.pdf [hereinafter "OCC Comment"].

13 OCC Comment: BBVA, Compass Bancshares, BMO Financial Corp, Capital One, CIT Bank, NA, Citizens Financial Group Inc., Discover Financial Services, KeyBank National Association, The PNC Financial Services Group, Inc., Regions Financial Corporation, and Zions Bancorporation (Sept. 21, 2017) *available at* https://www.regulations.gov/document?D=OCC-2017-0014-0049.

14 OCC Comment: Mike Quintanilla, FX Director, First Tennessee Bank (Aug. 3, 2017) *available at* https://www.regulations.gov/document?D=OCC-2017-0014-0003.

new compliance processes on top of existing processes, and the overwhelming consequence of the compliance program rules has been increased costs and uncertainty."[15]

- "The current business-as-usual Volcker processes at Credit Suisse, for example, require a significant dedication of resources that cannot be leveraged from other compliance efforts."[16]

The Coalition asks that the Agencies consider the downstream effects of the Volcker Rule on banking entities' counterparties and clients. Downstream actors also need to be considered appropriately by the Agencies, as commercial end-users are acutely sensitive to, and are affected by, costly regulations that affect their counterparties and intermediaries, including the Volcker Rule.

b. Commercial End-Users Have Realized Material Risks and Have Paid Higher Costs Stemming from the Volcker Rule's Regulatory Obligations, Which Are Directly Placed on Covered Banking Entities

When managing commercial risks through derivatives or engaging in capital raising activities, commercial end-users generally choose bank counterparties and bank-affiliated intermediaries. Large bank counterparties provide critical market making services, enhance liquidity and offer cost-savings due to economies of scale. Coalition members rely heavily on these covered bank entities for meeting their commercial risk management needs.

Since its implementation, we believe that the cumulative effects of the Volcker Rule on banking entities, as noted above, have been passed along to and realized by commercial end-users in the following two material ways: (i) market makers and underwriters have been less willing to provide market liquidity since the implementation of the rule, which has materially affected end-users' ability to meet short-term capital needs and transact in niche industries that require more tailored solutions; and (ii) end-users have found trading to be more expensive as a result of Volcker Rule compliance costs that are passed along by their counterparties.

i. The Volcker Rule stifles market liquidity; the Proposed Rule should work to enhance regulatory certainty and encourage covered banking entities to provide liquidity to underserved and niche markets.

Deep market liquidity is critical to a commercial end-user in order to ensure that the end-user maintains an effective risk management program. Liquid markets enable the end-user to effectively and efficiently access and transact in the markets and products necessary to mitigate commercial risk.

The Volcker Rule has served to curtail the full potential of the markets in which end-users transact, the result of which may largely be attributable to the ambiguities faced by covered bank entities

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[15] OCC Comment: International Swaps and Derivatives Association (Sept. 21, 2017) *available at* https://www.regulations.gov/document?D=OCC-2017-0014-0043.

[16] OCC Comment: Credit Suisse (Sept. 21, 2017) *available at* https://www.regulations.gov/document?D=OCC-2017-0014-0062.

when interpreting the Volcker Rule's RENTD standard in the underwriting and market making exemptions. We believe that the complexity in navigating these exemptions has caused a chilling effect on certain relatively illiquid markets, further exacerbating liquidity issues. Consequently, we understand that the counterparties and intermediaries that end-users increasingly rely on are less willing to underwrite and hold inventories of securities and other financial instruments as a result of the interpretive uncertainties surrounding the Volcker Rule.

Less liquid capital markets make it especially difficult for end-users to raise capital in times of market stress. In the period of time following the implementation of the current Volcker Rule, the U.S. economy has largely sustained a period of market stability, which has allowed end-users to freely access deeply liquid capital markets. If, however, market conditions were to worsen, we believe that the current rule would stifle the ability of commercial end-users to access capital markets at a period of time when they need that access the most.

For example, many end-users use their assets as collateral against short-term borrowings. To facilitate this kind of transaction, an end-user will often post certain of its assets as collateral against a short-term loan from a bank or sell its assets to the bank in a repo style transaction. In many cases, the end-user will post or sell physical assets or certain of its deliverable commodity forwards as collateral or under a repo transaction. However, in recent years, some end-users have found that their bank counterparties have curtailed some of their short-term lending and repo activities and in other cases found that banks have applied higher discounts to the value of the posted collateral. The negative effects of less short-term lending and repo activities by banking entities may render such hedging transactions economically inefficient for the end-user (*i.e.*, due to illiquidity in certain assets and transactions, there may be a greater discounts applied by a bank). While not on the same scale as the 2008 financial crisis, the negative cyclical consequences in this scenario are strikingly similar, where commercial businesses are unable to access short-term borrowing markets to weather an economic downturn or otherwise satisfy their short-term liquidity needs.

These concerns have also been noted by U.S. regulators. A Federal Reserve study found that in times of financial stress, the rule would likely have a deleterious effect on corporate bond liquidity.[17] In addition, SEC Commissioner Hester M. Peirce also articulated this concern, noting that "market-making is essential to the healthy functioning of our financial markets and the broader economy, and hedging is central to a banking entity's prudent risk management, particularly in times of market stress. I worry that it is precisely during a period of significant market stress that we may fully come to appreciate the downsides of increasing the legal risk for companies engaging in these activities."[18]

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[17] Jack Bao, Maureen O'Hara, and Alex Zhou, *Finance and Economics Discussion Series: The Volcker Rule and Market-Making in Times of Stress*, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board (Sept. 2018) *available at* https://www.federalreserve.gov/econresdata/feds/2016/files/2016102pap.pdf; *see also* Duffie (stating that the Volcker Rule will reduce the overall quality and capacity of market-making services provided to U.S. investors).

[18] Commissioner Hester M. Peirce, *Statement at Open Meeting on Amendments to the Volcker Rule*, Securities and Exchange Commission (June 5, 2018) *available at* https://www.sec.gov/news/public-statement/statement-peirce-060518-2.

Similarly, access to liquid markets is also critical to the stability of end-user counterparties. The inability to off-load assets in times of financial stress would only serve to further deteriorate a financial institution's health. An academic analysis by the University of Michigan, National University of Singapore and Harbin Institution of Technology supported this position, finding 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.[19]

In short, commercial end-users remain concerned that the downstream effects of implementation of the Volcker Rule has and/or will become an impediment to their access to the liquid markets necessary to promote safe and sound risk mitigation practices. The Volcker Rule was intended to mitigate systemic risks instead of posing greater risks of further exacerbation in times of financial market stress; and precisely when commercial companies are reliant on the derivatives and other financial markets to help stabilize losses and further mitigate risk.

For those reasons, the Coalition is strongly supportive of the Agencies' efforts to address the Volcker Rule's interpretive ambiguities. Regulatory clarification would help to provide the liquidity end-users need in order to efficiently and effectively manage their unique business risks.

ii. The Volcker Rule increases transactional costs for commercial end-users; the Proposed Rule should implement revisions designed to mitigate end-user counterparty costs.

In addition to liquidity concerns, covered banking entities have realized higher compliance costs as a secondary effect of the Volcker Rule's exemptions and associated RENTD standard.[20] These higher compliance costs borne by covered banking entities are passed along to commercial end-users when they engage in hedging transactions with covered bank entities.[21]

For example, consider a manufacturing company that has decided to invest in a new plant to serve its customers' growing need for its products. Ideally, the manufacturer would match the term of the

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[19] Sohhyun Chung et al., *The Impact of Volcker Rule on Bank Profits and Default Probabilities*, Working Paper (June 19, 2016) *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2167773 (finding 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).

[20] *Id.* ("In addition to directly deterring critically important economic activities, the substantive complexity of the Volcker Rule imposes significant compliance costs on bank-affiliated broker-dealers and investment advisers, forcing them to divert resources away from more productive activities.").

[21] Charles K. Whitehead, Testimony Before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Securities and Investments, *Hearing on "Examining the Impact of the Volcker Rule on Markets, Business, Investors, and Job Creation"* (Mar. 29, 2017) *available at* https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-cwhitehead-20170329.pdf (noting that the Volcker Rule's effects on corporate bond liquidity has resulted in increases to investors execution costs. "The challenge is not how much capital is raised, but the incremental cost to issuers of raising it – a cost that affects Main Street as much as it affects Wall Street.").

funding for the new plant with the expected long-term cash-flows, as uncertainty about the interest cost over the life of the investment increases the risk of the investment and could curtail some projects.

To mitigate these risks prior to the Volcker Rule's implementation, the manufacturer has issued its commercial paper with the interest rate changing (*e.g.*, every thirty days), and also enters into an interest rate swap that fixed the interest rate over a long term to match the expected long life of a new plant. This type of hedging strategy used to enable manufacturers to transfer interest rate risk to a swap counterparty such as a bank that is in the business of managing this type of risk.

In recent years, however, we understand that bank derivatives counterparties are shifting toward offering shorter-term, more liquid hedging alternatives. We believe that this shift—from offering long-dated hedging products, to only offering shorter-term hedging alternatives—is in response to, among other things, Volcker Rule compliance.[22]

More specifically, we believe that the shift toward shorter-term hedging products is a result of the current rule's complex, prescriptive requirements and limited set of permissible financial instruments to manage liquidity risk. The resulting additional costs have led to higher transactional pricing terms when banking entities transact with commercial end-users. Accordingly we ask the Agencies to consider expanding the set of financial instruments that a banking entity may use to engage in liquidity management activities so that the costs that are ultimately borne by end users are lowered.

Higher transactional pricing for end-users when they enter into hedging swaps with banking entities seems contrary to the intent of the Volcker Rule. The Coalition has always held the position that their hedging swaps are risk reducing, not speculative and do not increase systemic risk. In short, the real-world application of the Volcker Rule has created a compliance regime that is subsidized, in part, by end-users paying increased transaction fees and bearing less-efficient pricing on their tailored risk-management solutions.

In recognition of the associated costs for both banking entities and their downstream end-user counterparties, the Coalition supports the Proposed Rule's attempt to mitigate these effects by making the market making exemption compliance program requirements applicable only to banking entities with significant trading assets and liabilities.[23] By adding interpretive clarity and streamlining this exemption, the Agencies will allow banking entities to develop compliance and liquidity risk management programs, which are more efficient and nimble. The Coalition also strongly believes that these benefits will ultimately reduce transaction costs for end-users.

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[22] The problem we note is twofold. As described above, RENTD uncertainties have exacerbated liquidity scarcity, as banks have expressed a general unwillingness to enter into certain long-dated transactions.

[23] Proposed Rule at 33438.

Thank you for your consideration of these very important issues to Coalition members. Please feel free to contact Michael Bopp at 202-955-8256 or at mbopp@gibsondunn.com if you have any questions or concerns.

Yours sincerely,

Coalition for Derivatives End-Users