From:	Kim, Charlene
To:	Comments
Cc:	John Court; McDowell, Carter; Sean Campbell; Alex LePore; Weiner, Benjamin H.
Subject:	[EXTERNAL MESSAGE] RIN 3064–AE79
Date:	Wednesday, October 09, 2019 3:29:22 PM
Attachments:	BPI-FSF-SIFMA Supp. Comment Letter (October 9, 2019) Regulatory Capital Treatment of TLAC Holdings.pdf

Further to the September 5, 2019 meeting among the OCC, FRB, FDIC, Bank Policy Institute, the Financial Services Forum and the Securities Industry and Financial Markets Association, attached is a supplemental joint comment letter from the Bank Policy Institute, the Financial Services Forum and the Securities Industry and Financial Markets Association on the OCC's proposal, issued jointly with the FRB and FDIC, *Regulatory Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies, Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations*.

The comment letter has also been submitted via email to the OCC and FRB.

Charlene H. Kim
Sullivan & Cromwell LLP | 125 Broad Street |
New York, NY 10004-2498
T: (212) 558-3614 | F: (212) 558-3588
kimc@sullcrom.com | http://www.sullcrom.com

FINANCIAL SERVICES FORUM

October 9, 2019

Via Electronic Mail

Chief Counsel's Office
Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, D.C. 20219

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

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

Re: Regulatory Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies, Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations (Docket ID OCC–2018–0019 and RIN1557–AE38; FRB Docket No. R–1655 and RIN 7100 AF43; FDIC RIN 3064–AE79)

Ladies and Gentlemen:

The Bank Policy Institute, the Financial Services Forum and the Securities Industry and Financial Markets Association (the "Associations")[1] welcome the opportunity to supplement our comment letter dated June 7, 2019 (the "June Comment Letter") on the agencies' proposal[2] addressing the regulatory capital treatment of advanced approaches firms' investments in certain unsecured debt instruments of U.S. GSIBs, foreign GSIBs and the U.S. IHCs of foreign

---

1 See Annex A for a description of each of the Associations.

2 84 Fed. Reg. 13814 (Apr. 8, 2019).

GSIBs ("Covered IHCs"), including debt that qualifies as total loss-absorbing capacity ("TLAC") but does not qualify as regulatory capital ("TLAC-eligible debt").

The Associations appreciate the agencies' consideration of the June Comment Letter as well as the opportunity to meet on September 5, 2019 (the "September Meeting") to discuss our comment letter with the agencies. The June Comment Letter and this supplemental letter seek to further efficiency and simplicity in regulation[3] by allowing the agencies to better effectuate the underlying policy goals of the agencies' proposal—to reduce interconnectedness risk in connection with the failure of a GSIB while promoting deep and liquid markets for TLAC-eligible debt.

As noted in the June Comment Letter and as discussed during the September Meeting, the Associations strongly support the maintenance of robust capital by all banking organizations as an essential tool for promoting safety and soundness. The Associations similarly support the maintenance of TLAC as fundamental to GSIBs' balance sheets and effective and orderly resolution. The Associations believe that any policy that reduces the marketability of TLAC-eligible debt should be compelling and carefully considered in the context of the larger regulatory framework. The ability for GSIBs to issue TLAC-eligible debt, particularly during times of stress, is critical to the safety and soundness of individual GSIBs as well as financial stability more generally. Issuing TLAC-eligible debt is also necessary for GSIBs to satisfy their TLAC requirements.

The proposal as drafted, however, could significantly constrain the ability of advanced approaches firms to make markets in TLAC-eligible debt and other debt instruments issued by U.S. GSIBs, foreign GSIBs and subsidiaries of foreign GSIBs, including Covered IHCs. Those constraints could significantly reduce the depth and liquidity of markets for TLAC-eligible debt, which, in turn, could make it both more expensive and more difficult for GSIBs to issue TLAC-eligible debt. The proposal would also introduce pro-cyclical elements into the bank capital framework because the proposed deductions would create significant constraints on market making in TLAC-eligible debt, especially during times of stress as market makers' CET1 capital may decline, which would correspondingly reduce the size of the general ten percent threshold. These issues arise from the fact that the proposed separate five percent threshold does not reflect how market makers actually operate and is not designed to address the critical role of derivatives in market making. Further, the measurement of the threshold and associated deductions on a gross long basis—instead of on a net long basis—exacerbates these issues.

We are also concerned that the proposal would impose requirements on advanced approaches firms that would be complex and impracticable to implement and that the breadth of

---

[3] *See*, *e.g.*, Federal Reserve, *Supervision and Regulation Report* (May 2019), at 1-2, *available at* https://www.federalreserve.gov/publications/files/201905-supervision-and-regulation-report.pdf; *Statement of Randal K. Quarles, Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System before the Committee on Financial Services, U.S. House of Representatives* (Nov. 2018), at 1, *available at* https://www.federalreserve.gov/newsevents/testimony/files/quarles20181114a.pdf; *Statement of Randal K. Quarles, Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System before the Committee on Banking, Housing and Urban Affairs, U.S. Senate* (May. 2018), at 1, *available at* https://www.federalreserve.gov/newsevents/testimony/files/quarles20190515a.pdf.

debt instruments subject to potential deduction could have unintended consequences, including by interfering with ordinary interbank transactions.

Further to the discussion during the September Meeting, this supplemental letter provides responses to specific questions and requests for additional information, particularly in light of the fact that, subsequent to the submission of the June Comment Letter, the agencies finalized revisions to the Volcker Rule that more closely link the Volcker Rule with the bank regulatory capital framework. The Associations continue to support the recommendations in the June Comment Letter and have focused this letter on responding to the agencies' specific questions and requests for additional information.

I. Executive Summary.

- The agencies should eliminate the proposed 30-business-day requirement because it is unworkable for many market-making activities, and the Volcker Rule would provide a better framework for assessing whether a position is held for market-making purposes.
    - Derivatives play an important role in market-making activities.
        - A market maker can provide investors liquidity and allow investors to de-risk through a variety of transactions.
        - Market makers can likewise enable investors to acquire a position or increase their exposure to an issuer or its securities through a variety of transactions.
        - The ability of market makers to provide long and short exposures to investors through both cash and derivative instruments promotes the depth and liquidity of financial markets.
    - The agencies should eliminate the proposed 30-business-day requirement because it would make the proposed separate five percent threshold unavailable for many market-making activities that support the depth and liquidity of the markets for TLAC-eligible debt, in particular derivatives-related activities.
    - An aging metric, such as the 30-business-day requirement, is fundamentally flawed as a mechanism to determine whether a derivative relates to market-making activities.
    - Using the framework of the Volcker Rule to identify which positions are held for market-making purposes would promote effectiveness, simplicity and efficiency in regulation, as well as the objectives of the proposed separate threshold.
    - Using the framework of the Volcker Rule instead of the 30-business-day requirement in the proposal would be consistent with and would accomplish the same objectives as the Basel Committee standard.
    - Because the proposed 30-business-day requirement is ultimately an arbitrary aging requirement, it could discourage GSIBs from making markets in TLAC-

eligible debt and could also lead to significant and disruptive changes in market-making strategies and behavior by GSIBs.

- The design and calibration of the proposed separate five percent market-making threshold must be revised in order for the threshold to allow advanced approaches firms to support a deep and liquid market for TLAC-eligible debt, including by measuring exposures subject to the threshold on a net long instead of a gross long basis.

  - A net long measurement is particularly important for derivatives positions because GSIBs do not buy and sell inventory positions, but instead provide clients with long or short synthetic exposure, which the GSIBs then hedge to reach a net exposure amount. Any gross measurement, if applied to derivatives positions, would result in fundamentally inaccurate calculations of economic exposures.

- The agencies should revise the scope of "covered debt instruments" to include only TLAC-eligible debt, determined under applicable home-country standards, in order to avoid adopting a definition that would be overly broad and impracticable to implement and that would have unintended consequences.

- A firm's holdings of its own covered debt instruments should be deducted from its TLAC resources, not Tier 2 capital, and only if the holding is of TLAC-eligible debt.

- Numerous other regulations have contributed to substantial reductions in the risks the proposal is intended to address, and the agencies should take the broader regulatory framework into account when assessing the design and calibration of the proposed deductions.

II. The agencies should eliminate the proposed 30-business-day requirement because it is unworkable for many market-making activities, and the Volcker Rule would provide a better framework for assessing whether a position is held for market-making purposes.

A. Derivatives play an important role in market-making activities.

Market makers are financial intermediaries. They are essential to the depth and liquidity of financial markets, including the markets for TLAC-eligible debt. Market makers provide liquidity to investors seeking to exit a position and enable investors to reduce their exposure to a position. They also enter into transactions enabling investors to acquire a position or increase their exposure to an issuer or instrument. Market makers transact through cash positions (*i.e.*, positions in the securities themselves) and derivative positions (*i.e.*, positions in instruments that reference the underlying securities). Cash instruments, such as the TLAC-eligible debt securities themselves, are central to the balance sheets of GSIBs and financial markets. Derivatives play an equally important role in financial markets, allowing both investors and market makers to establish and hedge exposures in an efficient manner that promotes the stability, depth and liquidity of financial markets for all instruments, including cash instruments.

The notional amounts of a firm's credit derivatives covered by the market risk capital rule provide an indicator of the significance of derivatives to the firm's market-making activities. As of June 30, 2019, the six largest U.S. GSIBs reported notional amounts for credit derivatives covered by the market risk rule aggregating $2.5 trillion where the GSIBs are the protection sellers (*i.e.*, where they have a long position with respect to the referenced obligation) and aggregating $2.6 trillion where the GSIBs are the protection buyers (*i.e.*, where they have a short position with respect to the referenced obligation).[4] This information is intended to highlight the overall significance of derivatives to market-making activities, and we would welcome the opportunity to discuss with the agencies, upon request, any additional data on the importance of derivatives to market-making activities that the agencies believe may be useful as they consider our comments and recommendations.

1. A market maker can provide investors liquidity and allow investors to de-risk through a variety of transactions.

Take, for example, an investor who holds debt securities of an issuer and is looking to liquidate its position or otherwise reduce its exposure to those debt securities. As one way of providing liquidity, a market maker could purchase the debt securities from the investor. In order to enable the investor to de-risk its position, the market maker could alternatively enter into a derivative transaction referencing the debt securities with the investor, with the derivative transferring the economics relating to the debt securities from the investor to the market maker.

These transactions would give the market maker a long exposure to the debt securities. In either case, the market maker would enter into an offsetting transaction, or the long exposure would itself serve as an offsetting transaction for another transaction, creating a short exposure to the debt securities. Importantly, market makers manage their risk exposures taking into account their net exposure to a given security or issuer across cash positions and derivative positions. Accordingly, a market maker may offset a cash long position obtained through the purchase of securities from an investor by selling the securities or by entering into a derivative to hedge its long exposure. Similarly, a market maker may offset a derivative long position obtained through entering into a derivative with an investor by selling the underlying security short or entering into another derivative to hedge its long exposure on the derivative transaction with the investor.

Unlike a cash long position, however, a long derivative position would not be offset by selling the derivative itself. Market makers do not typically "sell" a derivative position, which would entail novating the derivative position to another market participant. Novations are significantly less common than sales of cash positions, reflecting that a novation can be expensive and time consuming and cannot be completed nearly as easily as a sale of a cash position.

2. Market makers can likewise enable investors to acquire a position or increase their exposure to an issuer or its securities through a variety of transactions.

---

4 Source: FR Y-9C filings.

Here, take for example an investor who wants to gain exposure to the debt securities of an issuer. A market maker could sell the debt securities to the investor or it could enter into a derivative transaction referencing the debt securities with the investor, with the derivative transferring the economics relating to the debt securities from the market maker to the investor. These transactions would give the market maker a short exposure to the debt securities. As for the long exposures described above, here the market maker would similarly enter into an offsetting transaction, or the short position would serve as an offsetting transaction for another transaction, creating a long position. In either case, and irrespective of whether the short position arises from a cash or derivative position, the offsetting transaction could be a cash or derivative position.

3. The ability of market makers to provide long and short exposures to investors through both cash and derivative instruments promotes the depth and liquidity of financial markets.

Market makers stand ready to purchase and sell securities and enter into derivative transactions that assume or transfer the economics of a position. The transactions market makers enter into, and their ongoing availability to enter into those transactions, mitigates volatility, illiquidity and related price dislocations in financial markets. Deeper and more liquid financial markets make it easier and less expensive for companies to raise capital and obtain financing. This is equally true for GSIBs looking to raise capital or issue debt securities, including TLAC-eligible debt.

A liquid derivatives market promotes financial stability. For example, a liquid derivatives market allows long-term investors in bank securities, including TLAC-eligible debt, to reduce their exposures without needing to sell their securities. In the absence of a liquid derivatives market, a long-term investor in TLAC-eligible debt would generally be able to reduce its exposure only by selling the TLAC-eligible debt. Sales of any securities, including TLAC-eligible debt, could result in significant price volatility if conducted in sufficiently large quantities in a short time frame. Price volatility could have a number of adverse market effects, including making it challenging and significantly more expensive for a GSIB to issue TLAC-eligible debt. This is especially true during stressed conditions. Critically, derivatives offer an alternative way for a long-term investor to reduce its exposures by allowing the investor to hedge its exposures without selling its underlying positions. The presence of a deep and liquid derivatives market relating to TLAC-eligible debt therefore mitigates the risk of potential price volatility in the underlying securities as a result of investors seeking to reduce their exposures.

Derivatives are central to market-making activities. They allow both investors and market makers to establish and hedge exposures. Further, market makers manage their exposures on a net risk basis, taking into account both long and short positions across cash and derivatives positions. Market makers do not separately consider and risk-manage their cash positions and derivatives positions. Rather, they holistically consider the overall exposures and risks created—and mitigated—by their cash and derivatives positions. Accordingly, any regulatory framework intended to promote market-making activities should address both derivatives and cash positions. A framework that addresses only cash positions—such as the proposed separate five percent threshold—would not be “fit for purpose” given the role of derivatives in market making.

B. The agencies should eliminate the proposed 30-business-day requirement because it would make the proposed separate five percent threshold unavailable for many market-making activities that support the depth and liquidity of the markets for TLAC-eligible debt, in particular derivatives-related activities.

The proposal includes activity-based requirements for U.S. GSIBs and subsidiaries of GSIBs, limiting the separate threshold to positions held for 30 business days or less and for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits. The agencies should eliminate the proposed 30-business-day requirement because it would make the proposed separate five percent market-making threshold unavailable for many market-making activities, including activities that support the depth and liquidity of the markets for TLAC-eligible debt.

The proposed separate five percent market-making threshold would not be workable for many market-making activities, including derivatives-related activities. If a designated excluded covered debt instrument is not sold within 30 business days, the position would automatically and immediately be subject to deduction. There are a variety of reasons why a market maker may hold a position for more than 30 business days in connection with market-making activities. In the case of derivatives, and as noted above, a market maker would not ordinarily "sell" a derivative to another market participant. Rather, the market maker would enter into another transaction to offset its risk position arising under the derivative. The derivative with the investor may be on the books of the market maker for more than 30 business days, but the market maker would not retain an unhedged long position indefinitely—that is, the risk would not be "held" indefinitely but, rather, would be transferred through an offsetting transaction. Moreover, a market maker could hold a cash position for more than 30 business days if the cash position offsets—or hedges—a derivative short position that has a tenor that is longer than 30 business days.

For transactions that have a tenor of more than 30 business days, the 30-business day requirement would also create incentives for firms to exit and reestablish hedge periods every 30 business days in order to avoid a mandatory deduction from Tier 2 capital if the hedge position is held for more than 30 business days. Exiting and re-establishing hedge positions would result in firms incurring undue costs without furthering any supervisory objective or reducing any actual risk. Firms would incur transaction costs to exit and reestablish their hedge positions to avoid breaching an arbitrary 30-business-day limit.

Below are some examples of why the 30-business-day limit is unworkable and reflects neither the way market makers actually operate nor the role of derivatives in market making.

- Client A desires to have a short-term synthetic (*i.e.*, derivative) long exposure to the TLAC-eligible debt of U.S. GSIB 1. Accordingly, Client A enters into a total return swap referencing the TLAC-eligible debt of U.S. GSIB 1 with the swap dealer subsidiary of another U.S. GSIB (U.S. GSIB 2). The total return swap has a tenor that is longer than 30 business days, which could range from 31 business days to five years or longer, depending on the investment objective of Client A.

    - The total return swap provides U.S. GSIB 2 a short exposure to the TLAC-eligible debt of U.S. GSIB 1. Accordingly, in order to offset (or hedge) the short position,

the swap dealer subsidiary of U.S. GSIB 2 purchases the TLAC-eligible debt of U.S. GSIB 1 and holds the hedge position throughout the tenor of the total return swap. The hedge position is a long position.

- U.S. GSIB 2 will need to hold the TLAC-eligible debt for the full tenor of the transaction in order to hedge the total return swap with Client A, which would result in a deduction even though the position is clearly being held for market-making purposes.

- As noted above, the 30-business-day requirement would create incentives for U.S. GSIB 2 to exit and reestablish its hedge position every 30 business days, which would result in U.S. GSIB 2 incurring costs in connection with transactions that would not further any supervisory objective or reduce any actual risk.

➢ Client B desires to establish a long exposure to the TLAC-eligible debt of U.S. GSIB 1 through a credit default swap. Accordingly, Client B enters into a credit default swap referencing the TLAC-eligible debt of U.S. GSIB 1 with the swap dealer subsidiary of U.S. GSIB 2, with Client B as the protection provider and U.S. GSIB 2 as the protection purchaser. The credit default swap with Client B has a tenor that is longer than 30 business days, which, as in the example above, could range from 31 business days to five years or longer, depending on the investment objective of Client B.

- The credit default swap provides U.S. GSIB 2 a short exposure to the TLAC-eligible debt of U.S. GSIB 1. Accordingly, in order to offset (or hedge) the short position, the swap dealer subsidiary of U.S. GSIB 2 enters into a credit default swap with another market participant that provides a long exposure to the TLAC-eligible debt of U.S. GSIB 1 fully offsetting the short exposure under the transaction with Client B.

- U.S. GSIB 2 has eliminated its risk exposure to the TLAC-eligible debt of U.S. GSIB 1. It has a net risk position of zero. U.S. GSIB 2 will, however, continue to have the credit default swaps with Client B and the other market participant on its books throughout the tenor of the transaction with Client B.

- Because the tenor is more than 30 business days, the hedging transaction with the other market participant would result in a deduction under the proposed separate five percent threshold, even though U.S. GSIB 2 has a net long position of zero in connection with a market-making transaction.

- As noted above, the 30-business-day requirement would create incentives for U.S. GSIB 2 to exit and reestablish its hedge position every 30 business days, or novate its hedge position from one market participant to another every 30 business days. In either case, U.S. GSIB 2 would incur costs in connection with transactions that would not further any supervisory objective or reduce any actual risk.

➢ Client C desires to establish a short exposure to the TLAC-eligible debt of U.S. GSIB 1 through a credit default swap. Accordingly, Client C enters into a credit default

swap referencing the TLAC-eligible debt of U.S. GSIB 1 with the swap dealer subsidiary of U.S. GSIB 2, with Client C as the protection purchaser and U.S. GSIB 2 as the protection provider. The credit default swap with Client C has a tenor that is longer than 30 business days, which, as in the examples above, could range from 31 business days or five years or longer, depending on the investment objective of Client C.

- The credit default swap provides U.S. GSIB 2 a long exposure to the TLAC-eligible debt of U.S. GSIB 1. Accordingly, in order to offset (or hedge) the long position, the swap dealer subsidiary of U.S. GSIB 2 enters into a credit default swap with another market participant that provides a short exposure to the TLAC-eligible debt of U.S. GSIB 1 fully offsetting the long exposure under the transaction with Client C.

- U.S. GSIB 2 has eliminated its risk exposure to the TLAC-eligible debt of U.S. GSIB 1. It has a net risk position of zero. U.S. GSIB 2 will, however, continue to have the credit default swap with Client C on its books throughout the tenor of that transaction.

- Because the tenor is more than 30 business days, the transaction with Client C would result in a deduction under the proposed separate five percent threshold, even though U.S. GSIB 2 has a net long position of zero in connection with a market-making transaction.

C. An aging metric, such as the 30-business-day requirement, is fundamentally flawed as a mechanism to determine whether a derivative relates to market-making activities.

The agencies have recognized that an aging metric—such as the proposed 30-business-day holding period—does not provide useful information about the purpose of a derivative position. As part of their recent 2019 revisions to the Volcker Rule, the agencies noted that they "[e]liminate[d] inventory aging data for derivatives because aging, as applied to derivatives, does not appear to provide a meaningful indicator of potential impermissible trading activity or excess risk-taking."[5] The same rationale applies for eliminating the 30-business-day holding period—the proposed holding period requirement would not be a meaningful indicator of whether a derivative position relates to market-making activities.

An aging metric—such as the proposed 30-business-day holding period—measures the amount of time that certain assets and liabilities have been held by a firm. Here, the aging metric is aimed at limiting the proposed separate five percent threshold to positions held in connection with market making, and precluding a firm from including positions related to other activities, including long-term investing activities, in the threshold. An aging metric would not achieve that objective. A derivative is an ongoing contract that provides exposure to an

---

5 FRB, OCC FDIC, SEC and CFTC, *Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (Aug. 20, 2019) (the "Volcker Rule Revisions Adopting Release") at 204, *available at* https://www.fdic.gov/news/board/2019/2019-08-20-notice-dis-a-fr.pdf.

underlying reference instrument over its term and, as discussed above, it is not ordinarily transferred. As a result, a firm that wishes to mitigate the risk of a market-making derivative transaction would enter into an offsetting transaction, which could be a derivative with another counterparty. Since, in this common example, the original derivative remains on the firm's books while its risk is offset, the derivatives continue to "age" for purposes of the aging metric, even though the firm has exited its risk position and is not retaining any risk. The result is a data point—how long it has been since the inception of the derivative transaction—that does not indicate whether the derivative relates to market-making activity.

In addition, the time to maturity of a derivative is not an indicator of whether the derivative is entered into in connection with market-making activities. A derivative may be long-dated or short-dated based on investor demand. Therefore, long-dated derivatives, such as a 30-year swap hedging an investor's risk on a 30-year bond or a total return swap providing an investor with synthetic exposure to an underlying instrument for more than 30 business days, can be market-making transactions in the same manner as short-dated derivatives. Accordingly, measuring the length of time a derivative stays on a firm's books provides minimal, if any, information about whether the firm entered into the derivative in connection with market-making or other activities. As discussed below, the framework of the Volcker Rule offers a better approach to identify whether a derivative position (or any other position) relates to a firm's market-making activities.

D. Using the framework of the Volcker Rule to identify which positions are held for market-making purposes would promote effectiveness, simplicity and efficiency in regulation, as well as the objectives of the proposed separate threshold.

The Associations appreciate the important role that common standards established by international bodies and implemented by local authorities play in the global and local bank regulatory frameworks. The Associations also believe that the primary objective of any rulemaking by the agencies on bank regulatory matters should be the adoption of a rule that is appropriate for the United States, taking into account the way in which the rule would fit within the overall U.S. bank regulatory framework, as well as the characteristics of U.S. financial markets, the banking organizations that participate in those markets, and the investors and other market participants that rely on those markets. By using the framework of the Volcker Rule to identify which positions are held for market-making purposes instead of the 30-business-day requirement, the agencies could implement the Basel Committee standard in a manner that is more appropriate for the United States.

The recent revisions to the Volcker Rule more closely linked the Volcker Rule with the bank capital framework. In particular, the agencies recently revised the definition of "trading desk" in the Volcker Rule to align it with the anticipated implementation of the Basel Committee's revised market risk capital standard.[6] The agencies explained that aligning the Volcker Rule and market risk capital rule definitions is expected to (i) simplify supervisory

---

6 *See* Volcker Rule Revisions Adopting Release, at 12.

oversight, (ii) reduce complexity and cost for banking entities and (iii) improve the effectiveness of the Volcker Rule.[7] Using the framework of the Volcker Rule to identify market-making positions for purposes of the proposed TLAC holdings deductions would have the same benefits and further the policy objectives of effectiveness, efficiency and simplicity in regulation.

As discussed in the June Comment Letter, firms have designed and implemented systems and processes to comply, and demonstrate compliance with, the Volcker Rule's provisions on market making. These systems and processes are complemented by the Volcker Rule's requirements regarding documentation and metrics reporting. Introducing an additional framework to identify market-making positions—as contemplated by the proposal—would introduce undue burdens without a corresponding supervisory benefit.

Moreover, implementing two different supervisory frameworks to identify market-making transactions could result in confusion and uncertainty that interferes with supervisory oversight and firms' own day-to-day operation of their own activities. The establishment of multiple, inconsistent frameworks to define the same activity would also undermine the longstanding policy goals of coherence, consistency and simplicity in regulation.

Further, introducing an additional framework to identify market-making positions would be contrary to the legislative mandate the agencies have received to implement the Volcker Rule. The statutory text of the Volcker Rule excepts market-making activities from the prohibition on proprietary trading and directs the agencies, along with the SEC and the CFTC, to adopt rules implementing the Volcker Rule, including the exception for market making. The regulations implementing the Volcker Rule address which activities constitute permissible market making. Defining market-making-related activities in a different manner and introducing constraints on positions that are entirely permissible under the Volcker Rule but that would not meet the new, different standard—as the proposal would do—would be inconsistent with the mandate that the agencies received in the Dodd-Frank Act to implement the Volcker Rule and define the scope of permissible market-making activities.

E. Using the framework of the Volcker Rule instead of the 30-business-day requirement in the proposal would be consistent with and would accomplish the same objectives as the Basel Committee standard.

The Associations recognize that there is an explicit 30-business-day requirement under the Basel Committee standard,[8] which was intended to limit positions subject to the new five percent threshold to those held for market-making purposes. We also understand that the use of an aging-based metric—here, the 30-business-day requirement—reflects the fact that some

---

7 *See* Volcker Rule Revisions Adopting Release, at 93.

8 Basel Committee on Banking Supervision, *Standard TLAC Holdings: Amendments to the Basel III Standard on the Definition of Capital* (Oct. 2016), at 6, *available at* https://www.bis.org/bcbs/publ/d387.pdf.

jurisdictions do not have a separate, pre-existing regulatory framework for determining whether positions are held for market-making purposes. Accordingly, we appreciate that, in those jurisdictions, an aging requirement could serve as a simple proxy for whether a position is held for market-making purposes. However, in jurisdictions where there are mature and sophisticated frameworks to identify market-making positions (*i.e.*, the United States with the Volcker Rule), we believe those developed frameworks should be used instead of the simple, and ultimately arbitrary, aging requirement.

Using the framework of the Volcker Rule would accomplish the exact same objective as the 30-business-day requirement in the Basel Committee standard—to identify whether a position is held for market-making purposes. However, it would do so in a more precise and less arbitrary way. Using the framework of the Volcker Rule would make the threshold "fit for purpose" by, among other things, making the threshold workable for derivatives. Using the framework of the Volcker Rule would not lessen the stringency of the threshold, nor would it create a risk that GSIBs could use the threshold to avoid deducting long-term investments in TLAC debt. Rather, using the framework of the Volcker Rule would incorporate a number of additional conditions on the availability of the threshold that would not apply under the proposal. Unlike the proposal, for example, the Volcker Rule imposes monitoring, reporting and documentation requirements. If the framework of the Volcker Rule is used instead of the proposed 30-business-day requirement, a firm could include a position in the proposed five percent threshold only if the position satisfied the requirements of the Volcker Rule.

The Volcker Rule's monitoring, reporting and documentation requirements would facilitate the agencies' supervisory oversight and their ability to assess whether firms have demonstrated that market-making positions—and only market-making positions—are included in the five percent threshold. In particular, the Volcker Rule's reporting requirements, as currently in effect and as revised in the recently adopted amendments, provide that firms with significant market-making activities—including the U.S. GSIBs and Covered IHCs for which the proposed separate five percent threshold is relevant—must report detailed quantitative trading metrics on an ongoing basis to their regulators, including the agencies. The information provided through the metrics reporting requirements would allow the agencies to continually evaluate and monitor that U.S. GSIBs and Covered IHCs are including only market-making-related positions in the separate five percent threshold.

F. Because the proposed 30-business-day requirement is ultimately an arbitrary aging requirement, it could discourage GSIBs from making markets in TLAC-eligible debt and could also lead to significant and disruptive changes in market-making strategies and behavior by GSIBs.

The risk of an immediate and dollar-for-dollar Tier 2 capital deduction if a TLAC-eligible debt instrument in the five percent threshold were to be held for more than 30 business days could discourage firms from market making TLAC-eligible debt. If firms reduce their market-making presence in the markets for TLAC-eligible debt, the result could be substantial declines in the depth and liquidity of the markets for TLAC-eligible debt. Such declines would likely make it significantly more challenging and expensive for GSIBs to issue TLAC-eligible debt. Investors

could reduce their holdings of TLAC-eligible debt or demand higher yields on TLAC-eligible debt in light of the reduction in market depth and liquidity.

With the 30-business-day limit on market-making for TLAC instruments, firms that continue to make markets in TLAC-eligible debt would face ongoing pressure to sell down their TLAC-eligible debt positions before the end of the 30-business-day period in order to avoid a capital deduction. This would create arbitrary cliff effects, which could give rise to unnecessary transactions-related costs as well as potentially disruptive movements in the price of TLAC-eligible debt. Additionally, market-making activities could be distorted because hedge funds and other institutions could short the TLAC-eligible debt, or take other positions, knowing that the largest market-makers would face pressure to sell within an arbitrary time-limited (*i.e.*, 30-business-day) period.

A deductions framework that uses thresholds based on measures of capital is inherently pro-cyclical. During periods of financial stress, a firm's capital may decline. Because the thresholds are based on a firm's capital, a decline in capital would correspondingly reduce the size of the threshold. Here, the lower threshold would reduce a firm's capacity to serve as a market maker. The 30-business-day requirement would exacerbate pro-cyclicality. The arbitrary, aging-based requirement would provide stronger incentives for firms to reduce their market-making activities as financial market conditions deteriorate.

The treatment of excess holdings of excluded covered debt instruments—that is, holdings designated by a U.S. GSIB or a subsidiary of a GSIB as excluded covered debt instruments that exceed the five percent limit—could have a similar pro-cyclical effect. Under the proposal, excess holdings in excluded covered debt instruments would automatically and immediately be subject to deduction on a gross long basis. That treatment is unnecessarily punitive and would likely discourage use of the five percent threshold because a firm would not want to risk the punitive treatment of having an excess position, especially during stressed conditions in the financial markets.

III. The design and calibration of the proposed separate five percent market-making threshold must be revised in order for the threshold to allow advanced approaches firms to support a deep and liquid market for TLAC-eligible debt, including by measuring exposures subject to the threshold on a net long instead of a gross long basis.

A. A net long measurement is particularly important for derivatives positions because GSIBs do not buy and sell inventory positions, but instead provide clients with long or short synthetic exposure, which the GSIBs then hedge to reach a net exposure amount. Any gross measurement, if applied to derivatives positions, would result in fundamentally inaccurate calculations of economic exposures.

Applying the threshold on a gross long basis would unduly constrain the ability of firms to engage in market-making activities. As noted above, the punitive treatment of excess holdings of excluded covered debt instruments would likely discourage use of the proposed separate five

percent threshold. The practical effect of the punitive treatment would likely be to shrink the effective size of the threshold. To the extent firms decide to use the threshold, they would have strong incentives to use less than the full amount of the threshold. That is, firms would have strong incentives to maintain a substantial cushion of unused capacity in the threshold to mitigate the risk of an immediate Tier 2 capital deduction if the aggregate value of their excluded covered debt instruments, measured on a gross long basis, happened to cross the five percent threshold as a result of increases in market values.

Deducting excess holdings of excluded covered debt instruments on a gross long basis would also not reflect a firm's actual risk position. Take, for example, a U.S. GSIB that has a long exposure to another U.S. GSIB's TLAC-eligible debt under a credit default swap with a client, and an exactly offsetting short exposure to that TLAC-eligible debt under a credit default swap with another market participant. If the long position were subject to deduction under the proposal (which could happen if the position constituted an excess holding or if the position had a tenor longer than 30 business days), the U.S. GSIB would be required to take a capital deduction on account of a gross long exposure to another U.S. GSIB's TLAC-eligible debt even though it has no net risk exposure to that TLAC-eligible debt. If the other U.S. GSIB defaulted on its TLAC-eligible debt, the U.S. GSIB would concurrently recognize gains and losses on the credit default swaps that offset each other. Applying the threshold and related deductions on a gross long basis disregards the actual economic position of a firm.

IV. The agencies should revise the scope of "covered debt instruments" to include only TLAC-eligible debt, determined under applicable home-country standards, in order to avoid adopting a definition that would be overly broad and impracticable to implement and that would have unintended consequences.

Treating any *pari passu* or subordinated unsecured debt instrument that is not itself TLAC-eligible debt as a "covered debt instrument" could have a number of unintended consequences. In the June Comment Letter, we described how the proposed definition of covered debt instruments could interfere with ordinary interbank deposits. We do not believe the agencies should adopt the proposed definition with an exception for interbank deposits. Rather, the agencies should adopt an appropriately tailored definition.

An exception for interbank deposits would not address the excessive breadth of the proposed definition or the impracticability of implementing it. As explained in the June Comment Letter, it is not practicable for firms to determine whether unsecured debt instruments are "covered debt instruments" because making these determinations would entail a searching inquiry, potentially involving a review and analysis of hundreds (and in some cases thousands) of outstanding instruments of each issuer, and the information necessary to make the determinations is not readily accessible.

Moreover, adopting an overly broad definition of covered debt instruments and an exception for interbank deposits (one issue which has already been identified so far), presents a significant risk of future unintended consequences. The agencies have adopted a number of regulations that use very broad—and ultimately overly broad—terms in order to address specific types of transactions and risks. In a number of cases, the challenges presented by the broad terms have been identified only after the regulations have been adopted and firms have commenced work to implement and comply with the regulations. These challenges have

imposed costs and activity constraints on firms that do not provide a supervisory benefit or further any supervisory or policy objective. Further, these challenges have necessitated firms to seek exemptions for transactions and activities that were not intended to be addressed (and, in some cases, prohibited) by the regulations.

For example, under the clean holding company requirements in the Federal Reserve's TLAC rule, U.S. GSIBs are prohibited from entering into qualified financial contracts ("QFCs") with third parties unless the QFC is a credit enhancement. The definition of QFC captures any "securities contract," which is broadly defined to include, among other things, any contract for the purchase or sale of a security. An underwriting agreement is the contract for the purchase and sale of a security and, therefore, a securities contract and a QFC. The TLAC rule thus simultaneously directs U.S. GSIBs to issue TLAC-eligible debt to satisfy TLAC and long-term debt requirements and prohibits them from entering into the customary agreement to do so, an underwriting agreement with a syndicate that includes unaffiliated broker-dealers. The issues relating to the prohibition on underwriting agreements and other parent-company QFCs, including, among other things, compensatory equity awards to employees, were identified only after the final TLAC rule had been adopted and firms proceeded with their implementation efforts. This has necessitated temporary exemptions from the prohibition on parent-level QFCs with third parties, which has resulted in costs and uncertainty for U.S. GSIBs and also required the Federal Reserve to devote time and other resources to consider and respond to the implementation-related issues.

An approach of using overly broad terms in regulations and then excluding transactions and activities that are inadvertently captured by the regulations is inimical to the policy objectives of effectiveness, simplicity and efficiency in regulation. This is especially the case where the exclusions are addressed in temporary, iterative exemptive relief after the regulations have been finalized. To date, in both the June Comment Letter and in this supplemental comment letter, we have identified the issues the overly broad definition of covered debt instruments would create for foreign bank deposits. If the agencies add only an exception to foreign bank deposits without more appropriately tailoring the definition of covered debt instruments, recent experience would indicate a high likelihood that firms will identify other unintended consequences of the definition as they work to implement the final rule.

The use of an appropriately tailored definition would both mitigate the risk of unintended consequences and address the impracticability of implementing the proposed definition as well as the excessive breadth of the proposed definition. As noted in our June Comment Letter, the agencies could achieve their supervisory objectives by using an appropriately tailored definition. The clean holding company requirements in the Federal Reserve's TLAC rule and analogous provisions in the FSB's Final TLAC Term Sheet limit the amount of debt that a firm could issue that is not TLAC-eligible but is *pari passu* with or junior to TLAC-eligible debt. Further, as detailed in the June Comment Letter, the application of the proposed definition of "covered debt instrument" would impose significant operational burdens and, ultimately, would be impracticable to implement. Accordingly, we urge the agencies to adopt an appropriately tailored definition of covered debt instruments.

V. A firm's holdings of its own covered debt instruments should be deducted from its TLAC resources, not Tier 2 capital, and only if the holding is of TLAC-eligible debt.

Under the proposal, a firm would be required to deduct from Tier 2 capital its holdings of its own covered debt instruments, including positions that are not TLAC-eligible debt and for which there is no regulatory credit. As described in the June Comment Letter, this framework is unnecessarily punitive and is not necessary to achieve the objective of the own holdings deduction, which is to reduce double counting. This framework could also have a significant effect on the depth and liquidity of the markets for TLAC-eligible debt because U.S. GSIBs are typically the most active market maker in their own debt securities, including TLAC-eligible debt.

Consistent with the Basel Committee standard, if a firm's own holdings of TLAC-eligible debt are not eliminated (or derecognized) in consolidation, the position should be deducted from its TLAC resources, but not its Tier 2 capital. Similarly, holdings of a firm's own covered debt instruments that are not TLAC-eligible debt should not be subject to any deduction. Those instruments do not provide TLAC or any other regulatory credit. Accordingly, and as discussed in the June Comment Letter, deducting those holdings is unnecessarily punitive and not necessary to prevent firms from double counting own-funded TLAC instruments.

VI. Numerous other regulations have contributed to substantial reductions in the risks the proposal is intended to address, and the agencies should take the broader regulatory framework into account when assessing the design and calibration of the proposed deductions.

As noted in the June Comment Letter, there are other regulations that address interconnectedness risk in connection with the failure of a GSIB—the risk the proposal is intended to address. Examples of regulations that address interconnectedness risk relating to the failure of a GSIB include:

- *Restrictions on the terms of QFCs*, which mitigate the risk of destabilizing cross-defaults and close-outs under derivatives. The implementation and adoption of the ISDA protocols have also substantially reduced the risk of destabilizing cross-defaults and close-outs under derivatives contracts among market participants worldwide.

- *Mandatory clearing and margin requirements for uncleared swaps*, which mitigate counterparty credit risk and potential contagion effects if a participant in the derivatives market fails.

- *Single-counterparty credit limits*, which limit exposures among firms and establish the most stringent limits on a GSIB's exposures to another GSIB.

- *Recovery planning requirements*, which make it less likely that a GSIB will fail if it experiences financial stress.

- *Resolution planning and TLAC requirements*, which are designed to ensure that a GSIB could be resolved in an orderly fashion without creating financial stability risk.

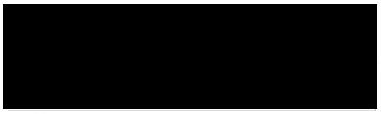
- *Capital, liquidity and capital stress testing requirements*, which increase the financial strength and safety and soundness of individual institutions, make institutions less susceptible to the risks of the failure of a GSIB and, in the case of the GSIB surcharge, impose higher loss-absorbency requirements intended to reduce the probability of a GSIB's failure.

* * * * *

The Associations appreciate the opportunity to supplement their June Comment Letter. If you have any questions, please contact John Court at (202) 589-2409 (*john.court@bpi.com*), Kevin Fromer at (202) 457-8787 (*kevin.fromer@financialservicesforum.org*) or Carter McDowell at (202) 962-7327 (*cmcdowell@sifma.org*).

Respectfully submitted,

John Court
SVP & General Counsel
Bank Policy Institute



Kevin Fromer
President and Chief Executive Officer
Financial Services Forum

Carter McDowell
Managing Director and Associate General Counsel
Securities Industry and Financial Markets Association

cc: Michael S. Gibson
Mark E. Van Der Weide
Board of Governors of the Federal Reserve System

Doreen R. Eberley
Nicholas Podsiadly
Federal Deposit Insurance Corporation

Jonathan Gould
Morris Morgan
Office of the Comptroller of the Currency

Annex A: The Associations

The Bank Policy Institute

The Bank Policy Institute is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost 2 million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

Financial Services Forum

The Financial Services Forum is an economic policy and advocacy organization whose members are the chief executive officers of the eight largest and most diversified financial institutions headquartered in the United States. Forum member institutions are a leading source of lending and investment in the United States and serve millions of consumers, businesses, investors, and communities throughout the country. The Forum promotes policies that support savings and investment, deep and liquid capital markets, a competitive global marketplace, and a sound financial system. https://www.fsforum.com/

The Securities Industry and Financial Markets Association

SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.