February 21, 2017

Via Electronic Mail

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Risk-based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-based Capital Requirements for Merchant Banking Investments (Docket No. R-1547; RIN 7100 AE-58)

Ladies and Gentlemen:

The Clearing House Association L.L.C., the American Bankers Association, the Financial Services Forum, the Financial Services Roundtable and the Institute of International Bankers (collectively, the "Associations")[1] appreciate the opportunity to comment on the Federal Reserve's recent notice of proposed rulemaking entitled Risk-based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-based Capital Requirements for Merchant Banking Investments.[2]

The proposal would, among other things, impose increased risk-based capital charges on merchant banking investments in companies engaged in physical commodities activities, and raises the prospect of future action to increase risk-based capital charges for all merchant banking investments as well as adjusting the Federal Reserve's risk-based capital rules to no longer consider merchant banking investments as "non-significant equity exposures." Given the significance and potential impact of the latter, our comments here focus on the appropriate

[1] Descriptions of the Associations are provided in Annex A of this letter.

[2] 81 Fed. Reg. 67,220 (Sept. 30, 2016).

capital treatment for merchant banking activities overall, and we do not address issues specific to physical commodity-related merchant banking investments.[3]

We believe the increases in risk-based capital requirements for merchant banking investments contemplated by the proposal are arbitrary, unsupported, and unnecessary, and we urge the Federal Reserve to retain its existing capital rules in this area. The proposal cites the risk of corporate veil piercing as the basis for increasing capital requirements. This risk, however, is extremely remote because of the high standard for imposing liability under a veil piercing theory. In the case of merchant banking investments, the risk is even more remote because the Bank Holding Company Act ("BHC Act") and Federal Reserve regulations generally prohibit an FHC from routinely managing or operating portfolio companies. The Clearing House conducted a data study on merchant banking activities to help provide an empirical basis upon which to assess the proposal, and we anticipate that study, the results of which The Clearing House intends to submit shortly as a supplement to this letter, will show that existing capital requirements are more than sufficient to insulate financial holding companies ("FHCs") against the risks posed by merchant banking investments based on an analysis of actual loss history. Further highlights of the anticipated results of the study, along with other key legal and factual considerations that we believe the Federal Reserve should take into account as it considers appropriate capital requirements for merchant banking, are discussed in greater detail below.[4]

As a threshold matter, we have several key concerns with the proposal:

- <u>The proposal would inappropriately undermine Congress's statutory grant of merchant banking authority and its allocation of joint rulemaking authority to the Federal Reserve and U.S. Treasury</u>. We note that the Federal Reserve has already

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3 Our comments respond to the Federal Reserve's statement that it is "considering the appropriate risk-based capital treatment for all merchant banking investments." Id. at 67,228 (emphasis added). Although we do not address in detail in this letter the proposed changes in the risk-based capital treatment for physical commodities-related merchant banking investments, we support the comments submitted on the proposal by the Securities Industry and Financial Markets Association ("SIFMA"), which address those issues. See Letter from the Securities Industry and Financial Markets Association to Mr. Robert deV. Frierson (Feb. 17, 2017) (the "SIFMA Letter").

4 The Clearing House study sought to (i) assess the size and scope of merchant banking activities conducted by FHCs, including asset management activities; (ii) determine the frequency with which FHCs routinely manage or operate merchant banking portfolio companies; (iii) identify any past instances of corporate veil-piercing; and (iv) assess whether current risk-based capital requirements are appropriate in light of historical loss experience. Twelve FHCs participated in the study and provided data on a best-efforts basis dating back as far as 2001. There were limitations in the ability of the participating FHCs to produce complete data across the entire period within the time allowed by the study and so our data set is admittedly somewhat incomplete (e.g., not all FHCs could produce complete data on all activity dating back to 2001). Moreover, with just twelve participating FHCs, our data set does not include every merchant banking investment ever made or sold by an FHC. Although not fully comprehensive, we believe the study includes the most comprehensive set of data publically available on this topic. If the Federal Reserve intends to propose rules to increase capital requirements for merchant banking investments, we urge the Federal Reserve to conduct a comprehensive data study similar to the one undertaken by The Clearing House that takes into account the full range of potential costs and benefits of imposing heightened requirements on merchant banking investments.

recommended that Congress repeal merchant banking authority in the report issued pursuant to Section 620 of the Dodd-Frank Act.[5] Although we disagree strongly with that recommendation, we believe the Section 620 Report – which requests Congress consider amending BHC Act authorities – is the proper route for the Federal Reserve to express its policy preferences with respect to a statutory authority like merchant banking. The Federal Reserve should not use a capital charge to effectively weaken significantly a clear grant of statutory authority to engage in this activity, and moot a clear grant of joint regulatory authority over this activity to the Federal Reserve and the Department of the Treasury. We are concerned not only about the inappropriateness of that charge in this context, but the precedent it would set for future use of the capital rules to effectively nullify Congressional grants of authority and allocation of rule-writing authority.

- <u>The proposal does not appropriately reflect and take into account risks to safety and soundness, the core objective of bank capital requirements</u>. The Federal Reserve's authority to impose capital requirements on merchant banking investments, as with any other asset type, is based on maintaining the safety and soundness of banks. Indeed, for the past 15 years, the Federal Reserve has approached merchant banking capital in exactly that way, imposing a sizeable capital charge on merchant banking investments that is generally commensurate with their absolute and relative risk, and consistent with international capital standards. Levying further capital requirements on merchant banking investments without empirical analysis or other evidence of risk to safety and soundness, however, would present a marked departure from the Federal Reserve's general approach to capital requirements, which has been and should remain grounded in risk-based analysis.

- <u>The proposed capital charges are based on asserted reputational and theoretical risks that are wholly unsubstantiated</u>. The proposal seeks to justify increasing risk-based capital requirements for physical commodity related merchant banking investments – and potentially for all merchant banking investments – by asserting that there are potential "reputational risks" and a theoretical possibility "that the corporate veil may be pierced," such that the FHC would be held financially responsible for liabilities of the merchant banking portfolio investment. But the proposal makes no effort to substantiate these assertions, and fails to identify either the likelihood of such scenarios or the magnitude of loss should they occur. Nor does it explain how the Federal Reserve erred in establishing its original capital rules for merchant banking in 2002 or amending them just three years ago, or the grounds on which it is reversing itself now. We are unaware of any change – and the proposal cites no change – in the law of corporate separateness over that

[5] See Federal Reserve, FDIC and OCC, Report pursuant to Section 620 of the Dodd-Frank Act (Sept. 9, 2016) (the "Section 620 Report").

period, and thus of any change (let alone increase) in potential "reputational risks."[6]

- The proposal makes no meaningful attempt to assess the cost of the proposed capital requirements in terms of a loss of funding for actual and potential investee companies, and the economy at large. Instead, it asserts that the impact of the proposed increase in capital requirements is "insignificant" because it would not materially increase FHCs' overall capital requirements. This statement is misleading, as it is indisputable that banks allocate capital by evaluating each activity relative to its specific share of their aggregate capital requirements, and establish hurdle return rates that factor into this charge. Thus, aggregate requirements are only a small portion of the business calculus as firms decide whether to retain and/or continue merchant banking (or other) activities in light of higher capital charges.

Noting these concerns, we believe the Federal Reserve should take into account the following key legal and factual considerations as it contemplates whether current capital requirements adequately capture the risks of merchant banking investments.

- Through merchant banking authority, FHCs contribute 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, including the renewable energy sector. For many of the companies in which merchant banking investments are made, replacing that capital could be difficult and costly. In addition, merchant banking authority complements other BHC Act authorities and, thereby, permits an FHC to provide a variety of services to its clients and the broader economy, including a range of asset management activities. The Clearing House study will include an empirical assessment of the extent to which FHCs rely on merchant banking authority for a range of activities, including "traditional" portfolio investments in shares of ordinary nonfinancial companies as well as tax-oriented investments in renewable energy projects (e.g., solar and wind farms). We anticipate the study will show that FHCs rely on merchant banking authority to provide roughly 40% of the annual renewable energy market's financing needs in the United States. We anticipate the study will also show that FHC asset management activities relying on merchant banking authority are substantial, and this is important to note as the scope and size of

6 The proposal describes no new material facts or developments regarding the veil-piercing risks associated with merchant banking investments. By failing to provide a more detailed justification for its new policy, which both rests upon factual findings that contradict those which underlay its prior policy and has engendered serious reliance interests of banks that currently hold illiquid merchant banking investments, the proposal is arbitrary and capricious under well-established principles of U.S. administrative law. See FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009) ("[T]he agency need not always provide a more detailed justification than what would suffice for a new policy created on a blank slate. Sometimes it must — when, for example, its new policy rests upon factual findings that contradict those which underlay its prior policy; or when its prior policy has engendered serious reliance interests that must be taken into account. It would be arbitrary or capricious to ignore such matters." (citation omitted).

these activities were omitted in Federal Reserve's own recent assessment of merchant banking activities in the Section 620 Report.

- The existing capital requirements for merchant banking investments are more than sufficient to cover the risks of these activities, irrespective of the nature of the operations of the portfolio company. The Clearing House study analyzes actual historical loss data associated with merchant banking investments, and we anticipate that the results will show that the current Basel III risk-based capital requirements are measurably higher than the 95th percentile of realized losses on merchant banking investments over the past 15 years (which, it is worth noting, included the most severe economic downturn in the post-war period).

- Any rule that would substantially limit an FHC's authority to rely on merchant banking authority (for example, by imposing substantially higher capital requirements) should carefully take into account the potential impact of that rule on FHCs and on their customers, markets, employment and economic growth.

I. Merchant banking authority enables FHCs to make important contributions to growth- and expansion-stage companies, employment and the economy and provides an important source of additional authority that can support other activities of FHCs.

We are concerned that the proposal, particularly when read in the context of the Section 620 Report's recommendations to Congress, raises the prospect of eliminating merchant banking authority altogether. In particular, the proposal requests comment on whether the risks associated with merchant banking investments in companies involved in physical commodity activities are different from or similar to other merchant banking investments and whether the Federal Reserve's current capital requirements adequately capture the risks of merchant banking investments not covered by the proposal.[7] However, neither the proposal nor the Section 620 Report explores the benefits derived from this authority or the negative impact that its elimination would have on employment and the economy. This impact would include, for example, the loss of investments in portfolio companies that encourage economic growth. Merchant banking authority also supports an important range of FHC activities, discussed further below.

A. Merchant banking investments by FHCs are an important source of funding for many companies and industries, including for renewable energy markets.

FHCs provide funding through merchant banking investments to companies that contribute to job creation and economic growth, including in emerging industries. The basic

7 See Question 4 of the proposal, 81 Fed. Reg. 67,228 (soliciting public comment regarding whether the risks associated with merchant banking investments in companies involved in physical commodity activities are different from or similar to other merchant banking investments and whether the Federal Reserve's current capital requirements adequately capture the risks of merchant banking investments not covered by the proposal).

premise underlying merchant banking activities is to provide capital and financial expertise to companies that have economic potential for growth and expansion and sound management teams. The emphasis of FHCs' merchant banking investments, therefore, is not short-term cost cutting or financial engineering but instead to provide capital and expertise to facilitate a long-term growth strategy.

Merchant banking investments by FHCs are an efficient tool for providing capital to companies and industries. As a complement to other BHC Act authorities, merchant banking authority affords FHCs the flexibility to contribute capital to different layers of a company's capital structure. For early-stage and growth-stage companies, merchant banking authority allows FHCs to provide an alternate form of financing to traditional bank loans and other capital markets instruments, which may be more expensive or unavailable to these companies. FHCs also provide an alternative to financing from private equity and venture capital firms, increasing competition for investment opportunities.

FHCs have made important contributions in particular industries, including developing renewable energy projects in markets such as wind and solar energy, renewable real estate and clean technology, as part of their merchant banking activity. Many FHCs are active in structuring investments in renewable energy projects that are eligible for tax credits and other benefits. FHCs are an important source of capital for projects eligible for tax incentives because the owners of renewable energy generation assets may lack the capacity to benefit fully from the tax benefit and few other market participants have the necessary capacity. FHCs are also well equipped to address competently the variety of complex legal and related issues that arise in making these investments. A high proportion of tax equity investments in wind and solar energy are made by FHCs using merchant banking authority and FHCs play a similarly significant role in most of the other renewable energy market segments. We anticipate The Clearing House study will show FHCs rely on merchant banking authority to provide roughly 40% of the annual renewable energy market's financing needs in the United States.

B. FHCs rely on merchant banking authority to engage in a variety of activities that provide significant benefits to FHC business models.

In addition to relying on merchant banking authority to make investments in a wide range of portfolio companies, FHCs often use merchant banking authority as a complement to other authorities under the BHC Act because it permits FHCs to own equity securities of non-bank companies on a temporary basis. Materially increasing capital requirements on a wider range of, or all, merchant banking investments could significantly reduce or eliminate the flexibility that the authority provides. We urge the Federal Reserve to consider these benefits in evaluating any additional capital requirements on merchant banking activities.

- The proposal considers only on-balance-sheet merchant banking investments and ignores the collateral consequences of increased capital requirements for activities where a relatively small merchant banking investment is a requisite component of a much larger overall banking activity. We anticipate The Clearing House study will show that the size and scope of FHC asset management activities relying on merchant banking authority are substantial, with total fund AUM in controlled merchant banking funds exceeding $200 billion in 2015.

- As part of an asset management business, an FHC may sponsor private equity and real estate funds that the FHC is deemed to control under the BHC Act, for example because it acts as general partner of the fund even though the FHC may have only a de minimis economic interest in the fund itself. Because these funds are controlled by an FHC, the funds themselves rely on merchant banking authority to make their underlying investments in non-financial companies. Without merchant banking authority, an FHC would, as a practical matter, be unable to sponsor real estate funds and private equity funds that are controlled and would be required to restructure existing, controlled real estate and private equity fund structures to break control. An FHC may also rely on merchant banking authority to make initial seed or co-investments in its sponsored and controlled funds (although an FHC's eventual exposure to the underlying investments of these controlled funds is limited by the Volcker Rule's limitation on proprietary investments in sponsored covered funds).

- An FHC may rely on merchant banking authority to provide funding to a company through a fund structure. For example, FHCs may provide funding that permits a utility that owns generation assets to dispose of these assets to help the utility manage the burden of maintaining generation assets. To facilitate the disposition of these assets by the utility, an FHC may, pursuant to merchant banking authority, sponsor a Volcker Rule-compliant infrastructure fund that will acquire the generation assets, using debt and equity provided by investors.

➢ Merchant banking authority permits an FHC to offer customized financing terms to its clients, including loans with warrants or similar features. Under Federal Reserve rules and interpretations, warrants held by an FHC in a company are treated as if the FHC owned the underlying equity securities.[8] Accordingly, in order to provide financing to a company in the form of a loan that includes warrants, an FHC may rely on merchant banking authority to the extent that other BHC Act authorities (e.g., Section 4(c)(6)) are not available with respect to a particular financing structure.

➢ Merchant banking authority can provide an additional source of authority for FHCs' securities underwriting activity, such as to hold securities that could not be sold at a favorable price in a firm commitment underwriting. If an FHC is unable to sell securities that it purchased in a firm commitment underwriting in a reasonable time period consistent with bona fide underwriting activities, the FHC may elect to hold the securities for investment purposes in reliance on, and subject to, the requirements

[8] See, e.g., 12 C.F.R. § 225.31(d)(1) (providing that a company that owns, controls or holds securities that are immediately convertible, at the option of the holder, into voting securities of a company controls the voting securities); 12 C.F.R. § 217.2 (defining "equity exposure" under the risk-based capital rules to include, among other things, a warrant that is exercisable for an equity security).

of merchant banking authority rather than sell the securities at an unfavorable price, which puts additional pressure on the issuer.

- Finally, merchant banking activities provide a diversified revenue source for FHCs and increase their resiliency by permitting them to hold assets and revenue streams that may not be as correlated with their other activities, thereby enhancing the safety and soundness of FHCs and financial stability more broadly.

Finally, we note that the Federal Reserve in the proposal did not take into account off-balance-sheet asset management activities conducted by FHCs and thereby inaccurately estimated the potential economic impact of the proposal.

II. The existing capital requirements for merchant banking investments are sufficient to cover the risks of these activities, irrespective of the nature of the operations of the portfolio company.

The likelihood that an FHC would be held liable for the operations of a portfolio company is extremely remote—whether the company is engaged in activities related to environmentally-sensitive commodities or otherwise. The proposal does not establish any empirical basis for imposing more stringent capital requirements on merchant banking investments and the loss experience to date does not justify increasing capital requirements for these investments. In addition, in response to Question 4, we support continuing to include merchant banking investments as exposures eligible to be treated as "non-significant equity exposures" under the Federal Reserve's risk-based capital rules.

A. The proposed increase in capital requirements is based on an unsubstantiated premise—that existing capital requirements are insufficient to address the potential liability from merchant banking investments.

The proposal would raise capital requirements significantly for certain merchant banking investments on the basis that existing capital requirements do not address the potential risk of the activity, including legal liability. However, just three years ago, the Federal Reserve, in implementing Basel III in the United States, revised and substantially increased the amount of capital that FHCs are required to hold with respect to equity exposures generally, including merchant banking investments.[9] In addition, an FHC subject to the advanced approaches is required to hold capital against operational risks, which include the risk of legal liability.[10] The

[9] See 12 C.F.R. §§ 217.52, 217.152. Under the standardized approach, a bank's total risk-weighted assets for equity exposures equals the sum of the risk-weighted amounts for each of its individual equity exposures. To the extent the aggregate adjusted carrying value of certain insignificant equity exposures in the aggregate do not exceed 10% of an institution's total capital, an FHC may generally apply a risk weight of 100% to such exposures; beyond that, equity exposures are generally risk weighted at 300 percent (for publicly traded companies) and 400 percent (for non-publicly traded companies). For so-called advanced approaches FHCs using internal models, the risk-weighted asset is calculated as the greater of the product of estimated potential loss and 12.5 and 200% multiplied by the adjusted carrying value of the FHC's public traded equity exposure (or 300% for non-publicly traded equity exposures).

[10] 12 C.F.R. § 217.101(b) (definition of "operational risk"); 12 C.F.R. §§ 217.161-162.

proposal provides little explanation and no evidence that these recent—and sizable—increases in capital requirements are not sufficient. Furthermore, the proposal does not take into account higher capital requirements for merchant banking investments imposed under the Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR"), which is the effective binding constraint on capital for many banks. For instance, merchant banking investments under the CCAR process attract punitive loss rates under the severely adverse stress scenario and, as a result, the capital held is multiples higher than the Basel III requirements currently imply.

The proposal's explanation for the proposed risk weights is that they are needed "to address the risks associated with merchant banking investments generally, the potential reputational risks associated with the investment, and the possibility that the corporate veil may be pierced and the FHC held liable for environmental damage caused by the portfolio company."[11] The proposal, however, provides no empirical or analytical support for these concerns and identifies no change in corporate veil piercing theory that would put in doubt its high threshold for liability.

The proposal similarly offers no support for the apparent determination that the doctrine of corporate separateness is insufficient to protect an FHC from losses on a corporate veil piercing theory, and does not describe any new legal developments that would warrant more onerous capital requirements on merchant banking investments. We are not aware of any material change in this doctrine since the capital requirements for merchant banking investments were revised three years ago,[12] or even since the original capital requirements for merchant banking investments were adopted in 2002.[13] In addition, the proposal does not distinguish the risk of veil piercing in the case of (i) a merchant banking investment where routine management of the investee company is prohibited (other than in limited circumstances) and eventual divestiture is required—in which case the likelihood is extremely low—versus (ii) directly owned and operated companies in which financial holding companies may invest under other authorities (e.g., sections 4(k)(1)(B), 4(c)(2) or 4(o) of the BHC Act)—where the risk is still remarkably low.

As discussed in the joint memorandum of law prepared for SIFMA by four law firms in connection with the proposal, 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 extremely remote.[14] The threshold for imposing liability on an entity on a veil piercing theory is high, reflecting the bedrock corporate law principle that a parent corporation is generally not liable for the acts of its subsidiaries.[15] The set of circumstances in which a parent corporation may be held liable for acts of a subsidiary generally involve a failure to adhere to

11 Proposal at 67,228.

12 See 78 Fed. Reg. 62,018 (Oct. 11, 2013).

13 See 67 Fed. Reg. 3,784 (Jan. 25, 2002).

14 See SIFMA Letter, Appendix A (the "Four-Firm Memo").

15 See Four-Firm Memo.

corporate formalities and a lack of corporate separateness between the entities.[16] However, Section 4(k)(4)(H) of the BHC Act and the Federal Reserve's regulations with respect to merchant banking activities already address these issues by generally prohibiting an FHC from routinely managing or operating any portfolio companies to address the very issue of corporate separateness.[17]

We anticipate The Clearing House study will show no evidence of corporate veil piercing for FHCs participating in the study over the past 15 years (using an FHC experiencing losses in excess of the FHC's invested capital as a proxy for veil-piercing). In addition, we anticipate the study will reveal that none of the FHCs participating in the study exercised routine management or operation over any merchant banking portfolio company during the 2015 calendar year.

In addition, Subpart J of Regulation Y requires that an FHC ensure the maintenance of corporate separateness by the FHC and protects the FHC and its depository institution subsidiaries from legal liability for the operations and financial obligations of the portfolio company.[18] The Federal Reserve has also provided supervisory guidance for merchant banking investments that focuses on, among other things:

- maintaining policies and procedures to ensure corporate separateness and avoid routine management of the portfolio companies, which are subject to Federal Reserve oversight as part of the supervisory process;
- ensuring oversight of merchant banking activities by the FHC's board of directors and senior management;
- managing effectively the investment process, including due diligence, investment analysis and approvals, investment risk ratings, periodic reviews, valuation and accounting and exit strategies; and
- instituting appropriate internal controls.[19]

FHCs may also hold insurance policies that cover potential liability arising out of merchant banking investments at multiple levels of the corporate structure. Specifically, as part of its due diligence in making a merchant banking investment, an FHC may consider the adequacy of the portfolio company's insurance coverage. The FHC may also maintain third-party environmental or pollution liability coverage with respect to risks that arise from its

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16 See Four-Firm Memo.

17 12 U.S.C. § 1843(k)(4)(H)(iv); 12 C.F.R. § 225.171(a).

18 12 C.F.R. § 225.175(a)(iv). In this regard, we note that the doctrine of corporate separateness and its protections were contemplated in the adopting release of the final merchant banking rule. See 66 Fed. Reg. 8,466, 8,478-79 (Jan. 31, 2001).

19 See, e.g., Supervision and Regulation Letter 00-8, Supervisory Guidance on Equity Investment and Merchant Banking Activities (June 22, 2000); Supervision and Regulation Letter 08-8, Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles (Oct. 16, 2008).

investment activities, including merchant banking investments. Therefore, in light of the regulatory and supervisory framework that applies to merchant banking investments and the general risk management practices of FHCs, the risk of veil piercing liability is extremely remote and, accordingly, any capital requirement should reflect this remoteness.

We are also concerned by the reference to “reputational risk,” which is susceptible to many interpretations and difficult to quantify.[20] The proposal does not cite any instances in which an FHC has faced any reputational or other risk as a result of merchant banking investments not covered by the proposal or in which an FHC experienced losses as a result of being liable for the operation of a non-physical commodity-related merchant banking portfolio company. More importantly, we have broad concerns about the increasing use of this vague standard in the regulatory and supervisory context as a justification for imposing higher capital charges or limits on bank activities as such actions could be viewed as simply a pretext for relevant agencies to subjectively limit or discourage activities that they simply are not partial to or feel political pressure to restrict.

Finally, the Federal Reserve should not impose a capital charge based on purely speculative and tail risks without empirical or analytical data to support that charge. To the extent (and only to the extent) that risks are realized or reasonably expected to occur based on substantive data, then a transparent, predictable and rational charge should be assessed commensurate with that of similar risks. But no such data for merchant banking has been proffered, and the related risks have never been, and are unlikely to ever be, realized. It would be inconsistent and unwise for FHCs to be required to hold significant capital against the tail risks relating to the (remote) possibility of facing liability on a veil piercing theory when FHCs are not required to hold significant capital for other risks that have a similarly low probability of materializing.

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20 House Financial Services Committee Chairman Jeb Hensarling has raised similar concerns about the use of “reputational risk” to dictate prudential policy – in his case it was in the context of CAMELS ratings, where he stated in a letter to Federal Reserve Board Chair Janet Yellen that “it would be an abuse of regulatory discretion to use vague, subjective and unquantifiable indicators like a firm’s reputation to justify regulatory outcomes that could not otherwise be justified under an objective CAMELS analysis…. The introduction of subjective criteria like ‘reputation risk’ into prudential bank supervision can all too easily become a pretext for the advancement of political objectives, which can potentially subvert both safety and soundness and the rule of law.” Interestingly, Chair Yellen in her response seemed to agree with the concern, stating that “examiners would not normally recommend that a banking organization change its business practices primarily on the basis that it is engaged in an activity that could result in reputational risk…to the extent that an activity poses significant potential reputational risk, examiners would expect supervised financial institutions to take steps to ensure that the activity is properly managed.” See Letter from House Financial Services Committee Chairman Jeb Hensarling to Federal Reserve Board Chair Janet Yellen, Comptroller of the Currency Thomas Curry, Federal Deposit Insurance Corporation Chairman Martin Gruenberg, and National Credit Union Administration Chairman Debbie Matz dated May 22, 2014; and letter from Federal Reserve Board Chair Janet Yellen to House Financial Services Committee Chairman Jeb Hensarling dated August 27, 2014.

B. The empirical loss data for merchant banking investments do not support imposing higher capital requirements.

Empirical analysis regarding merchant banking investments does not suggest that higher capital requirements are needed. In fact, to the contrary, the empirical data demonstrates that the capital requirements that currently apply to merchant banking investments are conservative. Specifically, we anticipate The Clearing House study will provide an empirical analysis demonstrating that, with respect to the participating FHCs, the current capital requirements are more than sufficient to cover losses on merchant banking investments.

III. Any future rulemaking that would limit the authority of an FHC to make merchant banking investments should take into account the impact on FHCs and on their customers, markets, industries and economic growth.

To ensure the credibility of the regulatory framework, it is important that all rules be implemented in a procedurally sound manner. It is even more important in the case of a significant change to a rule—particularly one that could significantly weaken a statutorily authorized activity and impact funding to the economy. We believe that the process should include a meaningful evaluation of the benefits of an activity and a thorough understanding of the potential impact on affected entities. The proposal meaningfully falls short of these standards and we request that this concern be considered in any future rulemaking addressing merchant banking authority. In addition, although we recognize that the Section 620 Report is not a rulemaking subject to formal procedural requirements, we were disappointed that it recommended the wholesale repeal of merchant banking authority without an assessment of the cost that would result if the recommendation were implemented or any discussion of the benefits of the authority. Adherence to these procedural standards is important in the context of the current proposal, but is even more important as the Federal Reserve continues to evaluate capital requirements for merchant banking activities more broadly, particularly given its Section 620 Report recommendation to repeal merchant banking authority.

The proposal does not adequately assess the cost of the proposed capital requirements.[21] Instead, the proposal merely states that the proposed increase in capital requirements for an FHC's covered commodity merchant banking investments is likely to be "insignificant" and "would not be expected to have a material impact" based on the aggregate value of merchant banking investments among FHCs.[22] First, this does not address the revenue benefits that FHCs derive from merchant banking investments. Moreover, this is an overly simplistic view of the way in which FHCs evaluate the capital requirements for their business. Among other considerations, FHCs determine the allocation of capital based on an analysis of each of its activities relative to its specific share of the FHC's aggregate capital requirements and establish hurdle rates that take into account the capital charge for each activity. Indeed, as the Federal Reserve is aware, banking organizations are required to report certain data regarding stressed

21 We acknowledge that capital requirements for a particular activity should be properly set through empirical analysis and analytical assessment of the risks posed to safety and soundness by the activity.

22 Proposal at 67,230.

capital requirements on a business segment basis for purposes of the annual CCAR exercise conducted by the Federal Reserve and determine capital allocation based, in part, on the results of that exercise.[23] Therefore, even if the aggregate capital requirements for a particular activity, such as merchant banking, appear to be "insignificant" in the context of an FHC's overall capital requirements, the capital requirement of a specific activity is only one variable that an FHC analyzes to determine whether to continue or discontinue that activity. Instead, the FHC will consider whether the activity meets the appropriate hurdle rate, factoring in the capital requirements. When the potential impact of heightened capital requirements is viewed in this context, the potential costs look different.

Indeed, when the impact to FHCs is appropriately analyzed, it becomes clear that FHCs necessarily would reduce activity in an area where the capital requirements are increased. Moreover, the "impact" analysis in the proposal addresses only the capital requirements of FHCs and does not begin to touch on the potential market impact of increasing capital requirements on these types of investments, including how reduced participation by FHCs in providing capital and financing to certain growth- and expansion-stage companies would affect development and the possible effects on economic growth and job creation. By the same token, the Federal Reserve does not analyze the benefits of merchant banking activities in the proposal. There is no discussion in the proposal of the importance of FHC involvement in providing capital to new and growing businesses and industries, such as in the renewable energy and renewable energy technology markets. More broadly, the proposal does not discuss any of the benefits of the authority discussed above in Section I or evaluate whether non-FHC market participants could fill the gap in the event that further restrictions on merchant banking activities limit these investments.

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23 See Federal Reserve, Instructions for the Capital Assessments and Stress Testing Information Collection, Reporting Form FR Y-14A (modified Nov. 30, 2016).

The Associations appreciate the opportunity to comment on the proposal. If you have any questions, please do not hesitate to contact any of the undersigned.

Respectfully submitted,

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ANNEX A

The Clearing House. The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C. is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly $2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

The American Bankers Association. The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $9 trillion in loans.

The Financial Services Forum. The Financial Services Forum is a non-partisan financial and economic policy organization comprised of the CEOs of the largest and most diversified financial services institutions with business operations in the United States. The purpose of the Forum is to pursue policies that encourage savings and investment, promote an open and competitive global marketplace, and ensure the opportunity of people everywhere to participate fully and productively in the 21st-century global economy.

The Financial Services Roundtable. *As advocates for a strong financial future*™, FSR represents nearly 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for $54 trillion in managed assets, $1 trillion in revenue, and 2 million jobs.

The Institute of International Bankers. IIB is the only national association devoted exclusively to representing and advancing the interests of the international banking community in the United States. Its membership is comprised of internationally headquartered banking and financial institutions from over 35 countries around the world doing business in the United States. The IIB's mission is to help resolve the many special legislative, regulatory, tax and compliance issues confronting internationally headquartered institutions that engage in banking, securities and other financial activities in the United States. Through its advocacy efforts the IIB seeks results that are consistent with the U.S. policy of national treatment and appropriately limit the extraterritorial application of U.S. laws to the global operations of its member institutions. Further information is available at www.iib.org.