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October 23, 2018

Joseph M. Otting
Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th St., SW
Suite 3E-218
Washington DC 20219
Via email:
VolckerReg.Comments@occ.treas.gov
Docket ID **OCC-2018-0010**

Ann E. Misback
Secretary
Board of Governors of the
Federal Reserve System
20th St. and Constitution Ave
Washington DC 20551
Via email:
regs.comments@federalreserve.gov
Docket No. **R-1608; RIN 7100-AF 06**

Robert E. Feldman
Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corp.
550 17th St., NW
Washington DC 20429
Via email:
comments@FDIC.gov
RIN 3064-AE67

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F. St., NE
Washington DC 20549-1090
Via email:
rule-comments@sec.gov
File No. S7-14-18

Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
1155 21st St., NW
Washington DC 20581
RIN 3038-AE72

Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (BHCA-4; OCC-2018-0010; R-1608; RIN 7100-AF 06; RIN 3064-AE67; File No. S7-07-18; RIN 3038-AE72)

Dear Ms. Misback:

CFA Institute[1] appreciates the opportunity to provide comments to the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the "Agencies"), on the proposed Revisions (the "Proposals") to the existing rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds[2] (the "Rule"). CFA Institute speaks on behalf of the nearly 170,000 investment professionals globally who are its members, and advocates for investor protection and market integrity before standard setters, regulatory authorities, and legislative bodies worldwide. We focus on issues affecting the profession of financial analysis and investment management, education and competencies for investment professionals, and on issues of fairness, transparency, and accountability of global financial markets.

Executive Summary

CFA Institute supports most of the Proposals to the general approach the Proposals would take toward continuing to prohibit or restrict proprietary trading and the ownership, sponsorship and direction of private investment funds. We believe depository financial institutions should not be able to access and use the liquidity and funding available to them through insured deposits to engage in such capital markets activities. The potential damage from institutional loss and systemic failure caused by missteps and failures in these activities would not only lead to potential difficulties fulfilling deposit insurance promises, but also would create volatile capital markets. The risk of either is too great to accept.

The Proposals, for the most part, represent appropriate and sensible reductions to the burdens imposed on the market-making and underwriting activities, in particular, of small and medium-size banking entities. We do not believe the magnitude of such activities as these institutions are at a magnitude, either individually or even likely collectively, to create systemwide failure in the financial system.

At the same time, we also recognize that such institutions typically have neither the experience, expertise, nor financial resources to draft, adopt, implement, and enforce effective compliance programs to manage such capital markets activities. We therefore support the concept of limiting market-making activity by use of the Reasonable Expected Near-Term Demand, or RENTD, for

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[1] CFA Institute is a global, not-for-profit professional association of more than 169,000 investment analysts, advisers, portfolio managers, and other investment professionals in 165 countries, of whom more than 162,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 149-member societies in 68 countries and territories.

[2] "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds: Final Rule, 79 FR 5535 (Jan. 31, 2014).

such services from clients, customers and counterparties. This methodology, we believe, offers a means of empowering banking entities to set their own limits based on experience, while operating under a mandate to promptly notify appropriate regulatory authorities of any breaches or changes to these limits. We also support the reservation of authority by the Agencies to withdraw the reduced the regulatory structure in favor of one more likely to preserve safety and soundness of individual institutions and the financial system, as a whole.

Finally, we note the concern raised by the Systemic Risk Council (the "SRC")[3] over the latitude granted large trading banks to determine whether activities are deemed market-making or hedging. We, like the Council, see this as a concern based on past experiences not only in bank regulation, but also with regard to financial reporting issues, where granting reduced constraints on certain reporting standards leads to interpretations that increasingly diverge from prior standards. In this case, the reduced constraints ultimately could lead depository institutions to use insured deposits to fund trading activities. We therefore reiterate the SRC's caution and urge the Agencies to devise an alternative approach.

Background

CFA Institute reiterates the support expressed for the overall purpose of the Rule[4] in our 2012 letter (the "2012 Letter"). Specifically, we continue to support restrictions on the ability of diversified financial institutions to use insured deposits to fund the active trading of investment securities in public and private capital markets. While we recognize neither the Rule nor the Proposals would prevent insured depository institutions from engaging in exempted market-making, underwriting, risk-mitigating hedging activities, or primary dealer activities, we nevertheless believe such institutions should not engage in these activities except through legally separate and separately capitalized and funded nonbank dealer subsidiaries or affiliates. The use of liquidity and funding derived from insured deposits, even if indirectly, poses both a competitive advantage for depository institutions while putting the deposit insurance fund at risk.

At the same time, CFA Institute supports the Agencies' attempts to improve the Rule through the Proposals, specifically as they relate to the purchase and sale of Treasury, municipal securities, and mortgage-backed securities by small and mid-sized banks. Such institutions have long used such instruments as part of their liquidity management activities and therefore shouldn't be penalized for such prudent activities.

We are concerned, nevertheless, that the Proposals could ultimately lessen the restrictions and oversight imposed on the capital markets activities of large and systemically important banks. While we recognize that restricting market-making may have negative consequences on trading

[3] The SRC is organized and funded by CFA Institute to monitor and address high-level systemic risk matters. Its opinions are those of its members and are derived independently of CFA Institute. Likewise, the views of CFA Institute are derived independently of the SRC. The similarity of views in this response indicates our independent concurrence of the SRC's position.
[4] See: http://author.cfainstitute.org/-/media/documents/comment-letter/2010-2014/20120215.ashx.

market liquidity, we nevertheless see the long-term effects of another systemic market meltdown having potentially more devastating effects on trust in financial markets. Therefore, we urge greater caution and continued vigilance on the largest banks to avoid such outcomes.

In the following pages, we address only those issues and questions in which we believe our expertise and experience are most applicable and useful.

Discussion

Subpart B—Proprietary Trading Restrictions (Qs 23-)

1. Prohibition on Proprietary Trading (Qs 23-63)

Definition of Trading Account (Qs23-38). The Rule currently determines whether a banking entity account is used for trading based on the institution's expressed intent for the account, and by how long a security is held by the institution. Specifically, a security is branded a trading asset if it is bought and sold within 60 days.

The Proposals would eliminate both the intention element of the rule, and the short-term holding presumption. In their place, the Proposals would adopt an accounting-based test based on two factors. First, the rule would label as a trading desk an activity that buys or sells securities financial instruments that its records at fair-value on a recurring basis under either Generally Accepted Accounting Principles ("GAAP") or International Financial Reporting Standards ("IFRS"). Instruments falling into this category would typically include derivatives, trading securities, and available-for-sale securities. Securities classified as trading securities under with GAAP or IFRS also would be deemed trading assets under the Rule.

CFA Institute View. We see the current bright-line 60-day period, within which the purchase and sale of a financial instrument may or may not trigger a determination of proprietary trading, as arbitrary. We could certainly see this capturing bank trades made for prudential purposes. Consequently, we support moving to an accounting-based test to determine the purpose of the accounts.

At the same time, in response to Question 28 on whether practical expedient to fair-value measurements permitted under accounting standards should be permitted within the trading account definition, we recommend the Agencies forego inclusion. A common standard for fair-value determination is needed for comparability purposes, both for investors and for regulatory supervisors. Ultimately, a common standard should reduce costs for issuers.

Presumed Compliance with the Prohibition on Proprietary Trading Restrictions (Qs 38-48). The Proposals would presume compliance with the Rule's proprietary trading restrictions if the "sum of the absolute values of gains or losses for each trading day in any 90-calendar-day period" does not exceed $25 million at any point during the period. The Proposal states this methodology will ensure that gains and losses are measured equally, thus ensuring that a trading desk could not offset large gains with equally significant losses to avoid triggering non-compliance. The agencies note they see this structure allowing banks to operate without assessing whether individual trades would put the bank in non-compliance with the rules.

CFA Institute View. As described, the Proposal's simplicity – using the aggregate absolute values for gains and losses during the period rather than net gains or losses — should make it more difficult for banks to gain an exemption to the Rule while not adhering to both its letter and intent. We believe this should ensure wide swings in interday trading are more difficult to mask a more aggressive trading operation, and therefore support the methodology used. The swift notification requirements for exceeding previously set thresholds is another important mechanism to quell repeated oversteps by a trading desk, and therefore a provision we support.

The Proposal notes that experience with the Rule shows aggregate quarterly gains or losses of $25 million over a 90-day period is the typical dividing line between those desks engaged in proprietary trading and those that are not. While we recognize the value in determining such a distinction for systemic purposes, we also recognize the risk such trading may create at the institutional level.

For example, a theoretical accumulation of $25 million in losses per day over the course of a quarter could amount to more than $1 billion, a sum that almost certainly would consume a significant portion of the equity capital of most small and many mid-sized banks. While such a scenario is highly improbable —consistent losses of that magnitude would likely attract the attention of the bank's senior management, its board, and its regulatory supervisors, all of whom would seek trading desk changes to end such a string of losses —, the accumulation of a number of days' losses at such a magnitude over a quarter could have a destructive effects on the equity capital of many banks, all without undermining a presumption of compliance with the Rule.

Based on these theoretical possible circumstance, we believe the Agencies should consider a potentially more useful and flexible alternative approach, albeit one that is potentially more complex. Specifically, a possible approach for small and mid-sized banks would apply a daily gain or loss threshold based on a percentage of reported equity capital from the prior quarter's-end.

In response to Question 41, wherein the Agencies inquire about what issues might arise if adoption of such the $25 million gain or loss threshold were adopted, we would suggest issues are likely to arise in the valuation of bespoke and illiquid instruments. In particular, the valuation of swaps, derivatives, and even illiquid debt securities are likely to become a point of contention, leading to questions about whether an institution exceeds, or falls below, established trading thresholds. To avoid such contention, and to make regulatory reporting consistent with reporting to investment markets, we recommend the Agencies adopt a valuation hierarchy similar to that applied by U.S. and/or global financial reporting standards. We also urge limitations on the ability of firms to receive exemptions for discrepancies in value. A more consistently applied standard will add certainty and trust into the process.

Excluded Activities: Reservation of Authority (Qs 60-63).

CFA Institute View. In Questions 60 through 62, the Proposal raises a series of issues, from which we will address three.

The first considers whether regulatory agencies should have the authority to determine whether a particular activity amounts to proprietary trading. We support such reserved authority as the Agencies, and the banking regulatory agencies, in particular, have a statutory mandate to address safety and soundness issues. As noted in the section above on *Presumed Compliance with the Prohibition on Proprietary Trading Restrictions*, we believe the Agencies need flexibility to address matters they see as undermining safety and soundness if they are to fulfill this mandate. At the same time, we believe the Agencies should keep such authority in reserve for use solely in those circumstances wherein poor management is putting an institution at risk of failure.

The second issue relates to issues arising from two agencies reaching different conclusions on determinations about trading activities. The lack of consensus in such matters in our view is likely to lead to regulatory arbitrage. The principal concern here, of course, is that institutions will ultimately gravitate to an agency whose decisions provide the most flexibility and latitude to bank management, and which may be determinantal not only to safety and soundness but also the full, fair and transparent disclosure of relevant information to public investors. Undermining either will lead to a loss of investor trust.

Finally, we support public disclosure when one of the Agencies determines that an institution's trading fails to comply with the Rule and the regulatory authority mandates corrective action. Withholding such information from investors will merely prolong the tenure of bank management that led to the regulatory actions. By keeping investors unaware ahead of growing problems by delaying disclosure will likely lead to a more significant market sell-off at could be an even more inopportune moment. We believe the Agencies should have consistent publishing practices to manage and mitigate exposure of such issues.

Beyond these matters, we support without comment the proposed changes to liquidity management requirements, exemptions for bona fide trading errors.

2. Permitted Underwriting and Market-Making Activities (Qs 64-)

Among other things, the Rule requires bank seeking an exemption for underwriting activities to prove it meets a series of tests for compliance. These include proof that the bank entity is licensed or registered to act as an underwriter, and that these activities are performed for the distribution of securities. It also has to prove that its securities inventory does not exceed pre-determined RENTD, and that it has and enforces an internal compliance program that includes internal controls, limits for each trading desk, and authorization procedures and reporting for exceptions to or changes in those limits. Banks also have to show that compensation for underwriting staff does not reward or incentivize prohibited proprietary trading.

The Proposals would eliminate the need for a banking entity to prove its underwriting activities comply with the Rule's list of requirements. Rather, banks would benefit from a presumption of compliance so long as it has internal risk limits that do not exceed its RENTD limits, based on the amount, type, and risk exposures of its underwriting positions. It would have to promptly report any changes or breaches to its risk limits. All of this would be subject to regulatory review. Banks with significant trading exposures would still need a comprehensive internal compliance program to get the exemption.

The Proposals would make similar changes to the compliance requirements for the market-making exemption. In this case, the bank would need to enforce internal risk limits no greater than the RENTD for each desk. RENTD in the case of market making also would have to consider the liquidity and maturity for the securities traded, and the market depth of the instruments used for risk management.

CFA Institute View. We believe the revisions are an appropriate means of both reducing the regulatory burdens on banks with limited or moderate trading and underwriting exposures, and continuing to appropriately monitor these activities to ensure banks respect the Rule's provisions.

While we recognize that small and mid-sized banks are unlikely to have large underwriting or market-making positions, they may take larger relative positions in both activities for local municipal bond offerings, or even local equity offerings. Our concern is that such institutions may not have strong internal controls, and therefore may be susceptible to the activities of a rogue trader. We therefore support the requirement for prompt reporting for any changes to or breaches of internally set risk limits. We also support giving regulatory authorities authority to impose stricter controls if they deem circumstances at a particular institution requires them (see our positions noted above in regard to Reservation of Authority).

3. Permitted Risk-Mitigating Hedging Activities (Qs 64-)

Under the Proposed Revisions, the Agencies would permit banking entities to create a list of pre-approved financial instruments they can and will use for hedging activities. The hedging activity would have to comply with the written, pre-approved limits for the relevant trading desk.

CFA Institute View. In its response to the Agencies[5], the SRC expresses concern about providing banks and their trading desks greater discretion over "what are 'market making' or 'hedging' services provided to clients." They note the decision of the Basel Committee to allow banks to use internal models to determine their capital needs and the troubles such discretion later created.

[5] See Systemic Risk Council — https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2018/08/SRC-Comment-Letter-on-eSLR-and-Volcker-Rule-Aug-8-2018.pdf

The SRC expresses concern that the changes would not "apply a meaningful constraint on speculating with FDIC-backed deposits," a position CFA Institute supports.

Subpart C — Covered Fund Activities and Investments

According to the Proposal, Section 13(a)(1)(B) of the Bank Holding Company Act "generally prohibits a banking entity from acquiring or retaining any ownership interest in, or sponsoring, a covered fund.[6]" The Agencies further note in the Proposal that defining "covered fund" is "central to the operation of Subpart C" of the Rule because it specifies to what types of entities the prohibition applies.

In general, the definition applies to private funds – those owned by fewer than 100 investors, or owned by sophisticated investors, and for which there is no current intent of launching a public offering of the securities. In general, the prohibition applies to hedge funds or private equity funds. It also includes funds organized and offered outside of the United States, as a mechanism to preventing circumvention of the Rule by use of foreign fund structures or certain commodity pools. Registered investment companies are excluded from this definition of covered fund regardless of how they are sold or distributed.

Section 23A of the Federal Reserve Act further prohibits a banking entity or its affiliates from buying assets, or lending or engaging in other transactions with a covered fund that the entity sponsors, advises, organizes, or offers. The purchase and sale of certain liquid assets are exempted from these prohibitions.

The Agencies note they are considering whether to permit banking entities to engage in limited transactions with covered funds they sponsor, advise, organize, or offer to investors.

CFA Institute View. We have concerns about the expansion of covered transactions beyond a very narrow list of transaction types. The potential for the funds to serve as both a liquidity mechanism and a means of off-loading poorly performing assets on unsuspecting investors, including institutional investors, is a relevant concern in our view.

We do not believe such an expansion is advisable, given the potential effects on investors, even sophisticated and institutional investors who are able to participate in private fund structures. While many such investor groups will be able to comprehend the potential effects such covered transactions may have on the performance of their investments, some may lack the ability to prevent such covered transactions from occurring, or to sell their interests to avoid such effects. Legal agreements may have unforeseen loopholes that could jeopardize the investors' returns. Exemptions in these cases would not help these investors.

[6] See 12 U.S.C. 1851(a)(1)(B).

<u>Subpart D — Compliance Program Requirements; Violations</u>

Appendix B of the Rule requires that banks engaged in covered trading and covered fund activities devise and apply a compliance program to ensure adherence to Rule's prohibitions and restrictions and to the Bank Holding Company Act. The program was mandated for banks with consolidated assets of $50 billion — $50 billion consolidated assets from US operations for foreign banks.

The Proposals would eliminate the enhanced minimum compliance standards and adopt a three-tiered regulatory structure principally based on the magnitude of the trading activities of the banking institution. Banks with "significant trading assets and liabilities" ("Large Trading Banks") would be defined as those with more than $10 billion in trading exposures, net of federal government obligations and those exposures benefiting from federal government guarantees. Large Trading Banks would have to adopt a 6-part compliance program which would include the requirements applicable to their trading activities, including this general list:

- Written policies and procedures
- Internal controls
- A management framework
- Independent testing and audit
- Training for relevant personnel
- Recordkeeping requirements

The Proposals expand CEO attestation to the existence, application, and applicability of a bank's compliance program to cover all Large Trading Banks. It also would subject these institutions to metrics reporting, covering such matters as inventory aging of derivatives activities, stressed value-at-risk measures for hedging desks, and use of XML formats for reporting these metrics. Regulators would collect names, identifiers, descriptions and activities for each trading desk.

Banks with net trading exposures of between $1 billion and $10 billion (Moderate Trading Banks) would be subject to CEO attestation of its programs to ensure compliance with the Rule and approved changes. At the same time, these institutions would face a simplified compliance program, which would prove compliance through updated policies and procedures.

Banks with net trading exposures of less than $1 billion, and foreign banks with U.S. exposures of less than $10 billion, would be deemed as having "limited" exposures ("Limited Trading Banks"), and therefore not required to demonstrate compliance with the rule, unless and until a regulatory agency concludes a compliance regime is needed.

<u>CFA Institute View.</u> In general, CFA Institute supports the Proposed Revisions' efforts to reduce the compliance burdens on banks whose trading activities do not present a significant risk to the health of either the institution or the health of the financial system. Likewise, we support maintenance of the more consequential requirements imposed on the Large Trading Banks.

At the same time, while the trading activities of Moderate Trading Banks and Limited Trading Banks may not present significant risks to the financial system or even the individual institution, we urge the Agencies to maintain diligence over all such activities and to avoid mistaking low exposures for good practices. Indeed, poor controls are likely more common at less-sophisticated institutions, and such inadequacies could permit a rogue trader to accrue large positions relative to an institution's capital without detection.

Conclusion

We support the Agencies' Proposals to reduce the regulatory burden on financial institutions whose trading activities were not the intended focus of the original Rule. We believe the structure contained in the Proposals do a good job of providing regulatory relief for institutions with moderate or limited exposures while ensuring compliance with both the intent and letter of the original Rule for banks of all sizes. Should you have any questions about our positions, please do not hesitate to contact Kurt Schacht, CFA, at kurt.schacht@cfainstitute.org, 212.756.7728, or James Allen, CFA james.allen@cfainstitute.org, 434.951.5558.

Sincerely,

/s/ Kurt N. Schacht

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