Center for American Progress

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July 7, 2017

Mr. Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

File Number S7-02-17

Re: SEC Release Nos. 33-10321, 34-80131; Request for Comment on Possible Changes to Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*

Dear Mr. Fields,

The Center for American Progress ("CAP") welcomes the opportunity to comment on the Securities and Exchange Commission's ("Commission") review of Industry Guide 3, *Statistical Disclosure by Bank Holding Companies* ("Guide 3"). CAP is an independent nonpartisan policy institute that is dedicated to improving the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action.

On April 13, 2016, the Commission invited public comment on a concept release regarding the modernization of certain company disclosure requirements found in Regulation S-K.[1] Several comments submitted in response to the concept release identified Guide 3 disclosure for Bank Holding Companies ("BHCs") as an area where the Commission should consider modernizing its disclosure requirements. In response to those comments, the Commission invited public comment on modernizing Guide 3 disclosure.[2]

As outlined in the notice for comment, the financial sector has undergone significant change since Guide 3 was first published in 1976.[3] The increased reporting requirements across financial regulatory agencies implemented as part of post-crisis financial reform efforts also makes this an appropriate time to review Guide 3 and ensure investors are best served by the disclosure regime for BHCs. Investors need a quality disclosure regime to make informed decisions based on the risk profiles of companies. A safe and sound financial sector is vital

[1] Securities and Exchange Commission, "Business and Financial Disclosure Required by Regulation S-K," *Concept Release*, April 13, 2016, available at https://www.sec.gov/rules/concept/2016/33-10064.pdf.
[2] Securities and Exchange Commission, "Request for Comment on Possible Changes to Industry Guide 3 (Statistical Disclosure by Bank Holding Companies)," *Request for Comment*, March 1, 2017, available at https://www.sec.gov/rules/other/2017/33-10321.pdf.
[3] Ibid.

for economic growth, and clear, robust disclosures will help shareholders make investing and governance decisions towards that end.

In the comments below, CAP outlines specific areas and ideas for the Commission to consider as it undertakes its review of Guide 3. The exclusion of certain topics or recommendations should not be interpreted as disapproval of those topics or recommendations.

Volcker Rule

Passed in the wake of the 2007-2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") included a key provision known as the Volcker Rule—owing its name to former Chairman of the Federal Reserve Board, Paul Volcker.[4] This provision, Section 619 of Dodd-Frank, required regulators to draft a rule that bans proprietary trading at Bank Holding Companies and their affiliates. The Volcker Rule also places limits on the ability of BHCs and their affiliates to own, sponsor, or invest in hedge funds and private equity funds. During the financial crisis, many of the largest, systemically important banks were taking swing-for-the-fence bets for their own profit – and often directly at the expense of their customers and clients. When the bets paid off, risk takers and bank executives received massive bonuses. When the bets turned sour, clients, other investors, and U.S. taxpayers were left holding the bag.

The system of large financial firms gambling with (directly or indirectly) government insured money, in which massive profits were privatized on Wall Street and catastrophic losses were socialized, was unacceptable. As noted by the Basel Committee on Banking Supervision in 2009, most of the build-up in leverage and ensuing losses on bank balance sheets during the crisis occurred in the trading book.[5] The "London Whale" incident in 2012, prior to the promulgation of a final Volcker Rule, serves as a recent reminder of the serious risks associated with these activities.[6]

On December 10, 2013, the five financial regulatory agencies responsible for drafting the Volcker Rule jointly issued a final rule with a conformance date of July 21, 2015. Over the past several years, banks appear to have restructured their trading activities—namely the elimination of their stand-alone proprietary trading desks, have made changes to their market-making and other relevant trading desks, and cut back their relationships with hedge funds and private equity funds because of the Volcker Rule.[7] The financial system is safer and

[4] For a thorough legislative history of the Volcker Rule, *See* Sen. Jeff Merkley and Sen. Carl Levin, "The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats," Harvard Journal of Legislation 48 (2) (2011): 515–553, available at http://harvardjol.com/archive/48-2/.
[5] Basel Committee on Banking Supervision, "Revisions to the Basel II market risk framework - consultative version," January 2009, available at http://www.bis.org/publ/bcbs148.htm.
[6] Patricia Hurtado, "The London Whale," Bloomberg, February 23, 2016, available at https://www.bloomberg.com/quicktake/the-london-whale.
[7] For example, see Tommy Wilkes, "Banks move high risk traders ahead of U.S. rule," *Reuters*, April 3, 2012, available at http://www.reuters.com/article/us-volckerrule-trading-idUSBRE8320GS20120403; Nelson

clients are better served today because of these restrictions. No longer can the largest systemically important banks quickly and dramatically, using high amounts of leverage, make speculative bets in the market, often against clients and customers. At the same time, the Volcker Rule has not harmed market liquidity. Contrary to the industry-led drumbeat, the data simply do not support the arguments that (1) fixed income liquidity overall is outside of historical norms or (2) that the Volcker Rule has had a negative impact on liquidity.[8] By some metrics, liquidity today appears to be even better than before the financial crisis.

Improvements, however, should be made surrounding the transparency of Volcker Rule implementation and compliance. Investors should be able to analyze how BHCs and systemically importance nonbank financial companies are complying with the Volcker Rule. In a letter to the five regulators responsible for the Volcker Rule, Americans for Financial Reform outlined certain compliance metrics that should be made public, including "reasonably expected near-term customer demand, profit and loss attribution, inventory turnover, inventory aging, and the volume and proportion of trades that are customer-facing."[9] Disclosure should be done on a desk-by-desk basis and should also include the nature of the trading desk's business and compensation arrangements for employees and supervisors of the desk and others directly responsible for the trading.

Disclosure should also cover all the positions held across the banking group in covered funds, as well as show the winddown of legacy positions over time.

Requiring these metrics be publicly produced would not only give confidence to academics, lawmakers, and the public that the Volcker Rule is working as intended. It would also provide investors the information necessary to evaluate how BHCs and systemically important nonbanks are adjusting their trading business to gear trading activities towards customer focused market-making and prudent hedging. Investors will appreciate greater visibility into the fast-moving trading book risks that caught so many of them off-guard during the financial crisis and London Whale debacle. Investors and companies will also benefit as more compliant firms should be better able to attract customer business. Better information about the market-making practices of critical central service-providers, such as the major BHCs, will improve market efficiency overall.

Schwartz, "Bank of America Cuts Back Its Prop Trading Desk," *The New York Times*, September 29, 2010, available at https://dealbook.nytimes.com/2010/09/29/bank-of-america-cuts-back-its-prop-trading-desk/; Kevin Roose, "Citigroup to Close Prop Trading Desk," *The New York Times*, January 27, 2012, available at https://dealbook.nytimes.com/2012/01/27/citigroup-to-close-prop-trading-desk/.

[8] Marc Jarsulic, "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation," Testimony before the U.S. House of Representatives Subcommittee on Capital Markets, Securities and Investment, March 29, 2017, available at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-mjarsulic-20170329.pdf

[9] Americans for Financial Reform, "Letter to Regulators: The Public Deserves More Transparency on Volcker Rule Implementation," December 17, 2015, available at http://ourfinancialsecurity.org/2015/12/letter-to-regulators-the-public-deserves-more-transparency-on-volcker-rule-implementation/.

Nor is there any material economic burden associated with the collection of these metrics, as they are already collected. And any burdens associated with distribution – such as being exposed to other firms trading against a firm's positions – are easily mitigated by a modest time-lag in disclosure. Ultimately, the clear and overwhelming benefit for investors to gauge how these Volcker-covered companies are making material business decisions to comply with the rule outweighs the minimal costs and makes the Guide 3 disclosure review an appropriate place to require these metrics.

Derivatives Exposures

The unregulated over-the-counter derivatives (swaps) market was one of the main drivers of systemic risk in the run-up to the 2007-2008 financial crisis. When used safely—either through regulated exchanges or bilaterally with robust initial and variation margin requirements and other protections—derivatives can help financial institutions and other end-users appropriately hedge their risks. But during the crisis, financial institutions were linked directly by unregulated derivatives in complex webs of risk that threatened to tear down the entire financial sector when the system incurred severe stress. Financial institutions failed to adequately manage the risks posed by these off-balance sheet instruments and regulators did not have the information necessary to accurately identify the buildup of this risk in the shadows of the financial sector. One additional complicating factor of the derivatives market during the financial crisis was that many swaps were "cross-border" in nature, meaning the contracts were conducted by the foreign subsidiaries of U.S. institutions or otherwise involved counterparties located in other countries. For example, much of insurance giant AIG's swaps business – the risks that resulted in its spectacular failure and federal bailout in 2008 – was conducted out of London.[10]

Title VII of the Dodd-Frank Act made significant progress on these issues. Many previously unregulated swaps are now centrally cleared and subject to margin, capital, and pre- and post-trade transparency requirements. The major financial market utilities that now serve as central counterparties in derivatives clearing are also subject to heightened risk management standards thanks to Title VIII of Dodd-Frank. Regulators have also significantly improved their access to derivatives market data and have worked with foreign market regulators on improved coordination over cross-border swaps market oversight.[11]

While this overall progress is encouraging, more can be done—especially regarding derivatives risk disclosure for investors. Viral Acharya from New York University's Stern

[10] Jay Shaylor, Lauren Pearle, and Tina Babarovic, "AIG's Small London Office May Have Lost Big," *ABC News*, March 10, 2009, available at http://abcnews.go.com/Business/story?id=7045889.
[11] Commodity Futures Trading Commission, "Cross-Border Regulation of Swaps/Derivatives: Discussions between the Commodity Futures Trading Commission and the European Union – A Path Forward," July 11, 2013, available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/jointdiscussionscftc_europeanu.pdf.

School of Business outlines different proposals to enhance derivatives transparency that should be considered by the Commission within the context of this Guide 3 review process.[12]

In addition to the proposals included in Acharya's paper, BHCs and other financial institutions should be required to disclose their derivatives exposure by country, providing details regarding whether and to what extent the exposures are guaranteed by the parent or any affiliate or subsidiary, the capitalization and margin collected by the relevant contracting subsidiary, and what would happen should the relevant subsidiary not be able to meet margin or capital requirements. Investors should be able to understand and evaluate the cross-border nature of a financial institution's derivatives contracts when making decisions. Cross-border derivatives pose a unique risk profile, given the coordinated nature of their regulation and the way financial stress in another region of the world can directly impact these derivatives—transmitting stress to U.S. institutions and markets. As SEC Commissioner Kara Stein makes clear in her June 2014 statement on cross-border swaps, "support arrangements between affiliates may take many forms. They may be oral, written, implicit, or explicit."[13] Commissioner Stein particularly highlights "keepwell" arrangements as a possible form of guarantee.

In their annual reports, BHCs currently disclose their lending and trading exposures by country, but do not separately break out information on cross-border derivatives.[14] Breaking this line item out by at least size, product type, locus of the issuing subsidiary, details regarding applicable margin and capital, and details regarding the guarantee relationship described above, will better enable investors to judge the risk of cross-border derivatives and should not require much additional effort on the part of financial institutions.

Nor is the collection or disclosure of this information particularly costly or burdensome. It is regularly collected by these firms to manage their own risks. Indeed, in instances where such information has not, in the past, been readily accessible to management and boards – as was the case for some firms during the financial crisis – that inaccessibility proved a major driver of default and bailout risk.[15] Better disclosure to investors will protect investors from such risks, allow investors to reward companies that manage their risks appropriately, and enhance market efficiency by reducing the negative externalities of bailouts. An updated Guide 3 must provide investors with visibility into this incredibly important risk of many large bank holding companies.

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[12] Viral V. Acharya, "A Transparency Standard for Derivatives," Working Paper 17558, November 2011, available at http://www.nber.org/papers/w17558.pdf.

[13] Commissioner Kara M. Stein, U.S. Securities and Exchange Commission, "Cross-Border Security-Based Swap Rules and Guidance," June 25, 2014, available at https://www.sec.gov/news/public-statement/2014-06-25-open-meeting-statement-kms.

[14] For example, S*ee* Bank of America 2016 Annual Report, p.73 available at http://media.corporate-ir.net/media_files/IROL/71/71595/BOAML_AR2016.pdf or J.P. Morgan Chase 2016 Annual Report, p.109 available at https://www.jpmorganchase.com/corporate/investor-relations/document/2016-annualreport.pdf.

[15] See, for example, discussion of the topic in Timothy Geithner, *Stress Test: Reflections on Financial Crises* (2014), and Andrew Ross Sorkin, *Too Big To Fail* (2009), among others.

Recovery and Resolution Planning

Post-crisis financial reform efforts not only aim to make failure of large complex financial institutions less likely, but also try to make safe and orderly failures possible. To that end, BHCs over $50 billion in assets and nonbank financial institutions designated as systemically important by the Financial Stability Oversight Council must submit resolution plans, or "Living Wills," to the Federal Reserve Board and Federal Deposit Insurance Corporation ("FDIC"). Living Wills outline how a financial institution could fail through bankruptcy. The resolution plans are also crucial for regulators in planning how to wind down a firm through the Orderly Liquidation Authority ("OLA"), a new tool that will be used by regulators if a firm's failure through bankruptcy would pose risks to U.S. financial stability.

These efforts to make orderly failure possible for large and complex financial institutions stems from the experience during the financial crisis with firms like Lehman Brothers, AIG, and more. Financial institutions and regulators did not have mechanisms in place to adequately plan for a firm's failure. And when a failure occurred, regulators did not have the tools they needed to handle that failure in an orderly manner. The only two options on the table were catastrophic bankruptcies (e.g. Lehman Brothers) or taxpayer funded bailouts (e.g. AIG). Both are unacceptable.

Through the Living Wills process, large BHCs and systemically important nonbank firms have worked to streamline legal entity structures, enhance liquidity and capital allocation frameworks, improve governance mechanisms and risk management, and more. Unfortunately, disclosure of the details of these plans and the process by which financial institutions develop and approach these plans has been insufficient.[16] Researchers at the Office of Financial Research ("OFR") analyzed the public portions of the Living Wills and noted that the data provided is limited and is not in a standardized format across the different Living Wills submissions.[17] This conclusion from OFR lines up with a Government Accountability Office ("GAO") report that found stakeholders interviewed by GAO generally did not find the public portion of the Living Wills useful.[18]

To appropriately evaluate the risks posed by these firms, investors should receive substantially more information about resolution planning and the submitted plans to regulators. Investors should be given enough information to determine whether management

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[16] Dennis Kelleher and Frank Medina, "Ending Too-Big-to-Fail by Breathing Life into 'Living Wills'," Better Markets Policy Brief, January 2016, available at https://www.bettermarkets.com/sites/default/files/Breathing%20Life%20Into%20Living%20Wills%20%282%29.pdf.

[17] Steve Bright and others, "What Can We Learn from Publicly Available Data in Banks' Living Wills?" Office of Financial Research Brief Series, May 25, 2016, available at https://www.financialresearch.gov/briefs/files/OFRbr_2016-05_Living-Wills.pdf.

[18] U.S. Government Accountability Office, "Resolution Plans: Regulators Have Refined Their Review Processes but Could Improve Transparency and Timeliness," Report to the Chairman, Committee on Financial Services, U.S. House of Representatives, April 2016, (pp. 48-49), available at http://www.gao.gov/assets/680/676497.pdf.

can develop and execute a resolution plan that preserves the most value for the firm. Moreover, there are significant regulatory risks associated with submitting Living Wills that are found to be not credible by regulators. Penalties include restrictions on growth and activities of the firm, increased prudential standards, and even forced divestiture if a firm continues to submit plans that are not credible. With such high stakes for investors, the Commission should consider, as part of this Guide 3 review, requiring firms that file a Living Will to disclose additional information on their resolution planning process and more information on the actual submission itself. Specific ideas on what should be included in enhanced Living Wills disclosures include clear detailed organizational charts of material entities, improved clarity on the challenges of cross-border resolutions, and more detailed information and charting of intergroup funding.[19] As a guiding principle, however, as much of the actual regulatory submission as possible should be made public. Some information that is clearly proprietary in nature should be withheld, but much of the currently withheld information does not fall into that category.

In addition to resolution planning, the Federal Reserve Board issued guidance to U.S. BHCs within the Fed's Large Institution Supervision Coordinating Committee portfolio—the eight BHC's that are globally systemically important banks—outlining requirements for recovery plans.[20] The Office of the Comptroller of the Currency ("OCC") also finalized guidance on recovery planning at banks it supervises with assets over $50 billion.[21] Recovery plans require firms to prepare a strategy for responding to times of severe financial stress at the institution, including viable options for restoring the firm's capital and liquidity positions. If recovery plans are thoughtfully-prepared, and well-executed when the firm incurs stress, then entering the resolution process can be avoided. Publicly disclosed information on recovery planning is limited. The Commission should consider requiring BHCs to disclose substantial information on their recovery planning process and recovery plans. The quality of the recovery plan and ability of management to execute the plan would have a significant impact on the shareholder value of the firm and the ability of the firm to avoid entering resolution. For that reason, investors should be given enough information to thoroughly evaluate these plans.

[19] Richard Herring, "Presentation on Living Will Transparency: Delivered to the Meeting of the Systemic Resolution Advisory Committee of the Federal Deposit Insurance Corporation," Meeting Minutes, December 10, 2014, available at https://www.fdic.gov/about/srac/2014/2014_12_10_minutes.pdf; U.S. Government Accountability Office, "Resolution Plans: Regulators Have Refined Their Review Processes but Could Improve Transparency and Timeliness"; Steve Bright and others, "What Can We Learn from Publicly Available Data in Banks' Living Wills?"

[20] Board of Governors of the Federal Reserve System, "SR 14-8: Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies," Guidance, September 25, 2014, available at https://www.federalreserve.gov/supervisionreg/srletters/sr1408.pdf.

[21] Office of the Comptroller of the Currency, "Enforceable Guidelines for Recovery Planning," Final Guidelines, September 29, 2016, available at https://www.occ.treas.gov/news-issuances/bulletins/2016/bulletin-2016-30.html.

Executive Compensation

Much of the excessive risk-taking on Wall Street in the run-up to the financial crisis was fueled, in part, by perverse incentives embedded within executive compensation packages.[22] When massive, swing-for-the-fence bets paid off, executives made millions due to the structure of their compensation packages, while the potential downside risk of those bets was not reflected in potential payoffs. As it turns out, the downside risk was left with U.S. taxpayers. When Wall Street's risky bets turned sour, they were bailed out. Yet executives were still receiving massive payouts, even as the financial crisis raged and the U.S. economy was in shambles.[23]

Dodd-Frank required the Commission and other regulators to develop rules to restrict these highly risky compensation practices and to provide more transparency to investors regarding the compensation incentives that influence management. The Commission, in coordination with other regulators where required, has adopted seven such rules on executive compensation, but five remain unfinished, including a very important joint rule on incentive compensation for financial institutions.[24] The Commission and other relevant regulators must finish those rules in a strong and robust manner.

But even while the Commission and other regulators consider how to proceed on the substance of executive and incentive compensation rules, the Commission can proceed immediately to enhance disclosure of BHC compensation practices. A focus of such enhanced disclosure ought to be the incentives around senior executive officers and significant risk-takers, as such concepts are laid out in the May 2016 proposal on Incentive-based Compensation Arrangements.[25] The proposal also set out a range of higher-risk incentive practices which it seeks to ban. At a minimum, the Commission should provide investors disclosure regarding whether any of those practices are still in place at any BHCs.

Disclosure of this information is neither costly nor burdensome and provides investors with highly material information to the operation and risk-structure of these financial firms.

Integrating Financial Reform Disclosures

The post-crisis financial regulatory framework's new rules on capital, liquidity, stress testing, and more have led to new disclosure requirements for BHCs and other financial companies outside of the Commission's disclosure regime. As part of its review of Guide 3, the

[22] Michael Corkery, "Executive Pay and the Financial Crisis: A Refresher Course," *The Wall Street Journal*, September 18, 2009, available at https://blogs.wsj.com/deals/2009/09/18/executive-pay-and-the-financial-crisis-a-refresher-course/.
[23] Louise Story and Eric Dash, "Bankers Reaped Lavish Bonuses During Bailouts," *The New York Times*, July 30, 2009, available at http://www.nytimes.com/2009/07/31/business/31pay.html.
[24] Securities and Exchange Commission, "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act," November 14, 2016, available at https://www.sec.gov/spotlight/dodd-frank.shtml.
[25] Dept. of Treasury Office of the Comptroller of the Currency, et al, 12 CFR Part 42, RIN 1557-AD39. Securities and Exchange Commission, 17 CFR Part 303, 240, and 275, Release No. 34-77776, May 6, 2016.

Commission should review the Dodd-Frank Act and Basel III related disclosures made on other financial regulatory reporting forms including the FR Y-9, FR Y-15, FFIEC 101, and FFIEC 102. Integrating new financial regulatory disclosures on issues including capital, liquidity, and stress testing into the Commission's Guide 3 disclosure regime would help investors access this information that may be currently published in disparate locations and formats by different regulators.

Data Reporting Standards

When publishing these and other disclosures, the Commission should require companies to adhere to best practices in data reporting formats, like eXtensible Business Reporting Language ("XBRL"). Investors must be able to analyze reporting data in a clear, structured manner.

Conclusion

The Center for American Progress urges the Commission to continue this important work to improve the disclosure regime for BHCs and appreciates the Commission's consideration of CAP's above recommendations. Much has changed in the financial sector since the Commission published Guide 3 for the first time in 1976. Modernizing Guide 3 to provide investors with more and better quality information on the risks posed by BHCs is crucial. The complexity of financial firms today is staggering. And with the much-needed improvements to the financial regulatory framework following the financial crisis, a thorough and thoughtful disclosure regime for these firms will only help investors make informed decisions in this important sector of the economy.

If you'd like more information on any of the proposed recommendations in this letter or would like to discuss these issues further, please contact the undersigned at [redacted] or [redacted].

Sincerely,

/s/ Andy Green
Managing Director, Economic Policy
Center for American Progress

/s/ Gregg Gelzinis
Special Assistant, Economic Policy
Center for American Progress