CENTER FOR CAPITAL MARKETS COMPETITIVENESS

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September 19, 2016

Mr. Scott G. Alvarez, Esq.
General Counsel
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Section 620 Report on Bank Investment Activities

Dear Mr. Alvarez:

The U.S. Chamber of Commerce's (the "Chamber") Center for Capital Markets Competitiveness ("CCMC")[1] writes to express our serious concerns with the recommendations of the Board of Governors of the Federal Reserve's ("Federal Reserve") "Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act" (the "Section 620 Report") and the lack of appropriate process and input in the drafting of the Section 620 Report and its resulting recommendations to repeal merchant banking authority and certain commodities activities of financial holding companies.

If the recommendations of the Section 620 Report are followed, the role of merchant banking in the capital formation process would be impaired compromising an important source of financing for businesses of all sizes, and in activities as important as capital raising, underwriting, and financing for start-ups and expansions. Yet, there was no public input into the process that led to the Section 620 Report or any economic analysis on the role of merchant banking in capital formation. Therefore, the Federal Reserve appears to ignore the important role of merchant banking as a provider of capital to businesses. This is even more troubling as statements from the Federal Reserve acknowledge the benefits of merchant banking outweigh *potential* risks, risks that have never manifested themselves. Consequently, through the Section 620 Report and its sweeping, though unjustified,

[1] The Chamber created the CCMC to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century global economy. The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector, and region.

recommendations, the Federal Reserve seems willing to sacrifice growth, undermining the very stability it seeks to enhance.

Accordingly, we would recommend that the Federal Reserve withdraw the Section 620 Report and perform such an analysis to better understand the scope of merchant banking, its role in capital formation and economic growth. We believe that the implications of this report are such that the Federal Reserve should seek public input into this report and consult other agencies, such as the Securities and Exchange Commission ("SEC") that has jurisdiction over capital formation issues.

Additionally, the process and resulting recommendations of the Section 620 Report reflect our continuing trepidations over the lack of a transparent and accountable regulatory process that led to the release of our report on needed reform of the Federal Reserve. Our report, ***Federal Reserve Reform: Securing Regulatory Transparency and Accountability***, points to key changes to rectify these issues in the future—many of which could have avoided the problems experienced in the drafting of the Section 620 Report. Many of these reforms can be implemented by the Federal Reserve now without legislation.

Our concerns are explained in greater detail below.

I. Circumvention of the Notice-and-Comment Rulemaking Process

Our strongest objection to the Section 620 Report is that the Federal Reserve failed to proceed with notice-and-comment rulemaking with respect to the recommendations made in its study, which has deprived stakeholders and the public with an opportunity to provide meaningful input. The Section 620 Report makes reference to an advance notice of proposed rulemaking ("ANPR")[2] released in January 2014 as one of the reasons the Federal Reserve made its recommendations in the Section 620 Report.[3] However, since the release of the ANPR over two years ago,

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[2] *See* Federal Reserve System, "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities," 79 Fed. Reg. 3329 (January 21, 2014).

[3] *See* Pgs. 27-28, "Report to Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act", Sept. 8, 2016, *available at* https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160908a1.pdf. The Section 620 Report was required to be issued within 18 months of enactment of the Dodd-Frank Act, which would have been January 21, 2012.

there has been **no** public opportunity to comment on the proposals made in the ANPR.

Instead, without explanation, the Federal Reserve has decided to recommend complete repeal of the ability of financial holding companies to engage in merchant banking activities and certain commodities activities with the release of this study. To our knowledge, there has been **no** stakeholder outreach on this issue since the release of the ANPR. This stands in stark contrast to the entire purpose of the ANPR, which is to "elicit views from the public on the risks and benefits" of engaging in certain commodities activities.

Even more importantly is the fact that there has been **no** opportunity whatsoever to comment on a repeal of merchant banking authority for financial holding companies. For over fifteen years, financial holding companies have been safely operating within the restrictions and limitations imposed on them under the rules implementing the merchant banking authority, and in so doing, they have provided crucial capital and financing to American start-ups and growing companies, which, in turn, creates jobs and fuels economic growth. To propose a complete elimination of this authority—without any opportunity for stakeholder input—is to act without any regard for any of the businesses that rely on continued investment as a result of merchant banking authority. It would also cut off access to that type of capital for any business currently seeking investment from a financial holding company through its merchant banking authority. This is a patently unfair deprivation of the ability of these businesses to access capital, especially at a time when financial regulatory reform has made access to credit all the more difficult.

Finally, we strongly believe that making these recommendations to Congress, rather than proceeding with the notice-and-comment rulemaking process,[4] presents a troubling precedent by which the Federal Reserve can ignore the comments made in an ANPR and instead recommend a change in policy based on its own judgment. Typically, an ANPR is subsequently followed by an additional opportunity to comment through a notice of proposed rulemaking, affording stakeholders the opportunity to consider the impact of a policy change in a more granular fashion. Instead, the Federal Reserve has "short circuited" the notice-and-comment

[4] We note that the Office of Comptroller of the Currency has proceeded with its recommendations through rulemaking, and we expect the Federal Deposit Insurance Company to do the same.

rulemaking process by making a recommendation to Congress based upon an option highlighted in the ANPR. In essence, the Federal Reserve has asked Congress to implement a final policy recommendation rather than proceed with its own rulemaking. This only creates a presumption of bad faith on behalf of the Federal Reserve, in that it would rather recommend a policy change to Congress, without the benefit of notice-and-comment rulemaking, than proceed with a rulemaking subject to the Administrative Procedure Act.

II. No Demonstration of Potential Benefits or Harmful Impact of Adopting Section 620 Report Recommendations

Along these lines, the Federal Reserve has failed to identify the potential benefits of repealing the ability of financial holding companies to engage in merchant banking and certain commodities activities. As noted above, businesses of all types and sizes have benefited from the ability of financial holding companies to make merchant banking investments and engage in certain commodity activities for over fifteen years. However, none of these benefits are mentioned in the Section 620 Report.

Moreover, the Federal Reserve itself acknowledges that there is no evidence of material loss resulting from such activities, with Federal Reserve Governor Dan Tarullo noting in an interview last week that:

> [T]hird, this is not an easy sort of thing for financial supervisors to oversee, making a judgment as to the safety and soundness of nonfinancial businesses that may be held in both geographic and corporate distance from the main operations of the firm. So our sense is that the benefits of this to the economy have been outweighed by the potential risks. And while it is true that to date we haven't seen one of these risks mature into an actual substantial loss, I think if there's a lesson from the crisis, it's that we should be trying to get ahead of potential risks and not waiting for disaster to befall us..."[5]

[5] Interview with Steve Liesman and Federal Reserve Governor Dan Tarullo, CNBC, September 9, 2016.

Accordingly, Governor Tarullo explicitly acknowledges that a hypothetical, unrealized risk somehow outweighs the real and demonstrable benefits of merchant banking. Furthermore, there is an acknowledgement that the Federal Reserve has a lack of understanding of the safety and soundness of non-financial businesses. Therefore, it would appear that the Section 620 Report and its conclusions are arbitrary and capricious and fail to take into account factors that can damage the overall economy.

Instead, what is needed before such recommendations are made to Congress or enacted into law is a thorough understanding of how businesses rely on the merchant banking and commodities related activities of financial holding companies, and how a potential repeal of either authority would impact their businesses. Repealing merchant banking authority presents an even larger set of concerns for businesses that have been able to grow due to access to these investment sources—including pension plans, endowments, charitable organizations, and similar institutions. This will have a further destabilizing impact on the business development and expansion. This is a serious issue for the stability and continued growth of the economy as we have witnessed a decline of over 50% in the number of public companies in the United States over the past 20 years. As we have highlighted in the past, repealing the ability of financial holding companies to transact in the physical commodities markets could negatively impact non-financial companies' ability to access efficient, transparent, liquid markets for managing their day-to-day physical commodity and related hedging needs.[6]

Finally, we believe that the potential costs of allowing financial holding companies to engage in these activities are remote and, at times, theoretical, meaning that the benefit of their repeal is strongly outweighed by the benefit of continued access to these services. The Section 620 Report discusses the need to safeguard the safety and soundness of the banking system in these circumstances by highlighting a hypothetical scenario in which legal risks could possibly arise to a financial holding company if one of its affiliates' corporate structures were "pierced." To date, there are no such examples of such "corporate veil piercing" actually occurring in the context of a financial holding company. In stark contrast, many commenters to the ANPR noted how remote this possibility actually was. Consequently, we fail to see

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[6] *See* Letter to the Federal Reserve re: Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities, Advance Notice of Proposed Rulemaking (Apr. 3, 2014), *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/2014-4.3-Fed-ANPR-Letter.pdf.

how the Federal Reserve justifies its repeal of merchant banking authority and commodities activities of financial holding companies on the basis of theoretical scenarios, which have been heavily criticized through the ANPR process.[7]

III. Necessity of Adopting Structural Reform to Address Process Issues

The numerous and grave procedural failures listed above have resulted in the release of recommendations that should not be taken at face value, and instead should be subject to rigorous and thorough analysis. This outcome could have been easily avoided if the Federal Reserve had adopted the reforms listed in our ***Federal Reserve Reform: Securing Regulatory Transparency and Accountability*** report.

For example, if the Federal Reserve had adopted a strategic plan subject to notice and comment, the public would have been aware that these recommendations were forthcoming and may have had an opportunity to provide meaningful input in advance of the Section 620 Report release. Many other federal financial regulators release such plans, and we see no reason why the Federal Reserve should be exempt from such requirements.[8] This is all the more important given that the study was technically required to be completed by January 21, 2012, meaning that the public has been "left in the dark" for over four years.

Our recommendation on publishing economic analyses subject to notice and comment for rulemaking is equally applicable to the Section 620 Report. While the study is not formally a rulemaking, its presentation to Congress as final policy recommendations will have the force and effect of law should the recommendations be enacted as a law. At the very least, the Federal Reserve should identify the benefits and costs of its proposed policy changes, especially when they are being presented as final policy judgments that should be codified.

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[7] We also note that the Federal Reserve draws an inappropriate reference to such legal liability arising under merchant banking authority, essentially arguing that such risks are present in every merchant banking investment. This is patently incorrect, as the merchant banking authority conferred by the Bank Holding Company Act permits financial holding companies to invest in a range of portfolio companies, all of which do not have the same investment or risk profile. We also note that, because merchant banking is by nature *idiosyncratic*, and not *systematic*, it is difficult to consider a scenario in which such investing poses a risk to the safety and soundness of the American financial system at large, rather than the failure of one investment.

[8] *See* Draft SEC Strategic Plan for 2014-2018, *available at* https://www.sec.gov/about/secstratplan1418.htm. The SEC strategic plan sought comment from the public on "the SEC's mission, vision, values, strategic goals, major initiatives, and performance metrics for fiscal years 2014 through 2018."

Finally, our recommendation regarding holding public meetings to consider regulations and other agreements is equally applicable to the Section 620 Report. To our knowledge, there were no public meetings or opportunities for stakeholder input in the development of this study, despite the fact that the Federal Reserve was required to consider factors such as "risk mitigation activities undertaken by the banking entity." The Federal Reserve may have benefited from more discussion with financial holding companies and other stakeholders about these activities, and thus developed a more robust report, had it asked those entities about their risk mitigation activities.

Conclusion

In sum, the Federal Reserve's Section 620 Report was undertaken through a fatally flawed process that did not consider stakeholder input, the impact of its recommendations on businesses that rely on the merchant banking authority and commodities activities of financial holding companies, and by circumventing any opportunity for notice and comment by issuing recommendations without thorough analysis as final policy judgments. Given these flaws, we strongly believe that the Federal Reserve should withdraw the Section 620 Report, seek public input into its recommendations, and consult with other agencies focusing on capital formation, such as the SEC. Until this occurs, Congress should not take the Section 620 Report recommendations at face value, especially without additional opportunities for stakeholder input.

Sincerely,

Tom Quaadman

cc: Mr. Charles C. Yi, General Counsel, Federal Deposit Insurance Corporation
Ms. Amy S. Friend, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency