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**Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (“Proposal”)<sup>1</sup>**

HSBC Bank USA, N.A., on behalf of itself and its affiliates worldwide (collectively, “HSBC”), welcomes the opportunity to provide the Agencies<sup>2</sup> with comments on the Proposal. HSBC appreciates the Agencies’ significant efforts in the Proposal to streamline the final rule adopted in December 2013 that implemented the Volcker Rule statute (“**2013 Final Rule**”)<sup>3</sup> and make a revised final rule (“**Revised Final Rule**”) more workable.

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<sup>1</sup> Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33605 (Jul. 17, 2018).

<sup>2</sup> Specifically, 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.

<sup>3</sup> Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5,536 (Jan. 31, 2014); Prohibitions and Restrictions on Proprietary Trading

We support the recommendations of the Institute of International Bankers, the Securities Industry and Financial Markets Association, the Investment Company Institute, and the European Banking Federation (organizations of which HSBC is a member). We are providing this supplemental comment letter to provide input on two issues on which we believe we can provide a unique and helpful perspective.

## **I. We Support the Proposed Elimination of the Counterparty Restriction under the TOTUS Exemption, But Request that the Proposed Modifications to the Conduct Restriction Go Further or Are Subject to Additional Guidance.**

### *A. Discussion*

The 2013 Final Rule’s permitted activity exemption for transactions outside the United States (“**TOTUS Exemption**”) permits a foreign banking entity to purchase or sell financial instruments as principal for the trading account, subject to several substantial, onerous, and complicated restrictions.<sup>4</sup> These include:

- **Counterparty Restriction.** The transaction may not be “conducted with or through any U.S. entity,”<sup>5</sup> with limited (and complex) exceptions.<sup>6</sup>
- **Conduct Restriction.** The personnel of the foreign banking entity or affiliate that “arrange, negotiate or execute” the transaction are not located in the United States.<sup>7</sup>

The Agencies state in the preamble to the Proposal that “foreign banking entities have communicated to the Agencies that these requirements have unduly limited their ability to make use of the statutory exemption for proprietary trading and have resulted in an impact on foreign banking entities’ operations outside of the United States that these banking entities believe is

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and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5,808 (Jan. 31, 2014)

<sup>4</sup> 2013 Final Rule § \_\_.6(e).

<sup>5</sup> 2013 Final Rule § \_\_.6(e)(3)(v).

<sup>6</sup> Specifically, a transaction “with or through a U.S. entity” is prohibited, unless it is: (i) “with the foreign operations of a U.S. entity if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation, or execution of such purchase or sale;” (ii) “with an unaffiliated market intermediary acting as principal, provided the purchase or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty;” or (iii) “through an unaffiliated market intermediary acting as agent, provided the purchase or sale is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.” 2013 Final Rule § \_\_.6(e)(3)(v)(A)-(C).

<sup>7</sup> 2013 Final Rule § \_\_.6(e)(3)(i).



broader than necessary to achieve compliance with the requirements of” the Volcker Rule statute.<sup>8</sup> This has been HSBC’s experience as well.<sup>9</sup>

In response to the concerns raised by foreign banking entities, the Agencies propose changes to the TOTUS Exemption. First, the Proposal would eliminate the Counterparty Restriction. Second, the Proposal would revise the Conduct Restriction to only prohibit “relevant personnel” (rather than any personnel that arrange, negotiate, or execute a transaction under the TOTUS Exemption) from being located in the United States, in order to make clear that “some limited involvement by U.S. personnel (*e.g.*, arranging or negotiating) would be consistent with [the TOTUS Exemption] so long as the principal bearing the risk of a purchase or sale is outside the United States.”<sup>10</sup>

## *B. Recommendations*

### 1. Counterparty Restriction

We support the elimination of the Counterparty Restriction. The Counterparty Restriction has created significant and unnecessary burdens for foreign banking entities, including HSBC. Determining whether a counterparty is a “U.S. entity,” as defined in the 2013 Final Rule,<sup>11</sup> is, as the Agencies recognize, “overly difficult and costly for banking entities to monitor, track, and comply with in practice.”<sup>12</sup>

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<sup>8</sup> 83 Fed. Reg at 33468.

<sup>9</sup> The Agencies also state in the preamble to the Proposal that “market participants have indicated that [the Counterparty Restriction] has in practice led foreign banking entities to overly restrict the range of counterparties with which transactions can be conducted” and note concerns that an overly narrow approach to the TOTUS Exemption may “reduce the efficiency and liquidity of markets” and “harm U.S. market participants”. 83 Fed. Reg at 33469 and 33470. This has also been HSBC’s experience. For example, under the Counterparty Restriction, a HSBC trading desk relying on the TOTUS Exemption is prohibited from entering into a transaction with the foreign operations of a U.S. entity unless no personnel of the U.S. entity that are located in the United States are involved in the transaction’s arrangement, negotiation, or execution. Therefore, the HSBC trading desk cannot enter into a transaction with a foreign subsidiary of a U.S. parent corporation if the subsidiary uses central treasury function personnel at its parent’s U.S. headquarters for arranging, negotiating, or executing the transaction, which limits the U.S. corporations’ foreign subsidiary’s access to financial services. § \_\_.6(e)(3)(v)(A).

<sup>10</sup> 83 Fed. Reg. at 33468.

<sup>11</sup> 2013 Final Rule § 6(e)(4).

<sup>12</sup> 83 Fed. Reg. at 33469. The Counterparty Restriction has also imposed costs and burdens on other market participants (including the foreign operations of U.S. entities) that are obliged to understand and provide the complex U.S. entity representations required of them by foreign banking entities’ trading desks that rely on the TOTUS Exemption.

Furthermore, the Counterparty Restriction does not promote the “safety and soundness” of the U.S. financial system.<sup>13</sup> The purpose of the Volcker Rule statute is to ensure that banking entities do not incur speculative, short-term proprietary trading risk that could impose losses on the U.S. federal safety net.<sup>14</sup> The location of a foreign banking entity’s counterparty has no impact on whether the foreign banking entity itself is incurring risk that could threaten the U.S. federal safety net because a foreign banking entity eligible for the TOTUS Exemption does not have access to the U.S. federal safety net, irrespective of the identity of the counterparty. As the Agencies allude to in the preamble to the Proposal, the Revised Final Rule should not focus on activity where the “risk of the transaction is borne outside the United States,”<sup>15</sup> such as a foreign banking entity’s transactions with U.S. counterparties that are otherwise permissible under the TOTUS Exemption.

Therefore, we strongly support the Agencies’ proposal to remove the Counterparty Restriction.

## 2. Conduct Restriction

The Conduct Restriction should also be eliminated entirely in the Revised Final Rule, rather than revised to only prohibit “relevant personnel” from being located in the United States. Like the Counterparty Restriction, the Conduct Restriction has created significant and unnecessary burdens for foreign banking entities such as HSBC but has no impact on the safety and soundness of the U.S. financial system because the location of conduct has no impact on the ultimate location of risk involved in a transaction, and therefore poses no risk to the U.S. federal safety net.

If the Agencies decide to implement the Proposal’s modified Conduct Restriction in the Revised Final Rule, however, we believe it would be helpful for HSBC and other foreign banking entities for the Agencies to clarify the meaning of the term “relevant personnel.” In particular, we believe that the Agencies should clarify that “relevant personnel” means personnel who set limits for, and subsequently manage, the risk of transactions booked to a trading desk that relies on the TOTUS Exemption. Specifically, “relevant personnel” should mean personnel who establish limits and transaction criteria for, and hedge the exposure of, the trading desk. “Relevant personnel” should not include personnel that execute a transaction in a purely operational sense and do not manage the trading desk’s risk, as such personnel do not have any impact on the decision to impose risk on the banking entity.

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<sup>13</sup> 83 Fed. Reg. at 33470.

<sup>14</sup> *Joint Economic Committee Holds Hearing on the Economic Outlook*, 111th Cong. 35 (2010) (statement of Federal Reserve Chairman Benjamin S. Bernanke) (noting that the intent of the Volcker Rule was to prevent banks from “taking speculative positions with the U.S. safety net behind it”).

<sup>15</sup> 83 Fed. Reg. at 33439.



For example, HSBC Bank plc (a foreign banking entity established in the United Kingdom) may have a non-U.S. client that wants to enter into a transaction after the close of UK business hours but before the close of U.S. business hours. In order to better serve the client, the client could be assisted by HSBC personnel in the United States that have authority to book off-hours transactions to a HSBC Bank plc trading desk that relies on the TOTUS Exemption, subject to limits and parameters pre-set by HSBC Bank plc personnel.<sup>16</sup> In such a scenario, the involvement of the U.S. personnel has no impact on the location or management of risk. The booking location of the transaction and its risk management is exactly the same (i.e., HSBC Bank plc) as it would be if UK personnel executed the transaction. U.S. personnel are merely performing an operational role in order to better serve a client. However, it is not clear whether this transaction would be permitted under the revised TOTUS Exemption that is set forth in the Proposal. We do not believe that this transaction should be prohibited under the TOTUS Exemption and, therefore, we believe that the Revised Final Rule should clarify that “relevant personnel” does not include personnel that execute a transaction in a purely operational-sense but have no role in setting the trading desk’s limits for, or managing, risk.

## **II. We Support an Explicit Clarification that a Market-Making Desk May Consider an Affiliated Trading Desk to be a “Client, Customer, or Counterparty” Where the Affiliated Trading Desk Transfers Client-Sourced Positions to the Market-Making Desk**

### *A. Discussion*

The market making-related activities exemption in the 2013 Final Rule (“**Market-Making Exemption**”) requires that a market-making trading desk’s inventory be designed not to exceed, on an ongoing basis, the reasonably expected near term demands (“**RENTD**”) of “clients, customers, or counterparties” (“**CCC**”).<sup>17</sup> While CCC is defined in the 2013 Final Rule, both the definition and the adopting release are silent on whether a market-making trading desk may treat an affiliated trading desk (“**Affiliated Desk**”) as a CCC. Although the Proposal does not include any specific concrete changes clarifying the treatment of transactions between Affiliated Desks, the Agencies recognize in the preamble to the Proposal the interpretive challenges of how to treat transactions between Affiliated Desks under the 2013 Final Rule and request comment on several scenarios in which a market-making trading desk would enter into transactions with an Affiliated Desk.

We appreciate that the Agencies have recognized this issue. The lack of clarity regarding transactions between affiliates, particularly where both Affiliated Desks are engaged in market-making activity, has been problematic for HSBC and other globally-active banking organizations that operate through multiple subsidiaries around the world.

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<sup>16</sup> HSBC and many other banks call this a “follow-the-sun” model.

<sup>17</sup> 2013 Final Rule § \_\_.4(b)(2)(ii).



HSBC provides services to clients around the world through locally-organized and locally-regulated subsidiaries (“**Local Sales Entities**”). By operating through Local Sales Entities, HSBC can better meet local clients’ needs through more personalized service; for example, a Local Sales Entity will be open during their local clients’ business hours, speak their local clients’ language, and better understand their local clients’ business needs. Each Local Sales Entity has an independently-managed balance sheet to ensure that it has sufficient resources and satisfies domestic capital, liquidity, and funding requirements. It would be inefficient, however, for each Local Sales Entity to manage the risk of all of its transactions independently. As a result, HSBC has historically used a trading structure that centralizes risk management by having trading desks at Local Sales Entities (“**Local Sales Desks**”) enter into transactions with Affiliated Desks in one of HSBC’s four primary jurisdictions (“**Hub Entities**”), such as HSBC Bank USA, N.A. in the United States or HSBC Bank plc in the United Kingdom.<sup>18</sup> Market making trading desks at Hub Entities (“**Hub Desks**”) then manage these positions along with the positions they take on as a market maker directly to third-party clients. It is because of this centralized risk management that Local Sales Entities are able to source positions for clients in a timely manner and at competitive prices.

As a result, while the Local Sales Desk faces local clients, the Hub Desk serves as the ultimate market maker for those clients. When a Hub Desk enters into a transaction with a Local Sales Desk, it does so to facilitate the Local Sales Desk’s client transactions by providing inventory to the Local Sales Desk and efficiently managing the risk of the resulting positions.

For example, a Local Sales Desk at HSBC Bank A.S. in Turkey transacts with local Turkish clients. If a local Turkish client requests a European security, the Local Sales Desk at HSBC Bank A.S. will source the security from HSBC Bank plc and sell it to the client. The Hub Desk, acting as the ultimate market maker for the local Turkish client, provides inventory to the Local Sales Desk and can manage any risk arising from these transactions more efficiently and with more expertise.

In our view, demand that originates from a third-party client through a Local Sales Desk and which the Local Sales Desk satisfies through a transaction with the Hub Desk is clearly client demand for the Hub Desk within the spirit of the Market-Making Exemption. However, because of the lack of clarity regarding whether a Hub Desk may treat a Local Sales Desk as a CCC, HSBC has excluded from the Hub Desks’ RENTD calculations client demand arising via Local Sales Desks. This unnecessarily prevents Hub Entities from holding inventory that genuinely reflects aggregated client demand, affecting HSBC’s ability to serve its clients globally. We do not believe the Agencies intended the 2013 Final Rule to result in these risk- and inventory-management inefficiencies, given that all of the transactions are client-driven.

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<sup>18</sup> HSBC’s other two Hub Entities are HSBC France S.A. in France and The Hongkong and Shanghai Banking Corporation Limited in Hong Kong.



*B. Recommendations*

We believe that the Revised Final Rule should reflect the realities of globally-active banking organizations that operate through multiple subsidiaries around the world (and of clients who seek efficient market solutions for their risk management needs) by expressly allowing a market-making trading desk to treat an Affiliated Desk as a CCC for purposes of RENTD where the Affiliated Desk is transacting with the market-making trading desk to be able to satisfy the demand of third-party CCCs.

As it relates to HSBC, we believe the Revised Final Rule should expressly permit a Hub Desk to treat a Local Sales Desk as a CCC for any transactions arising from the Local Sales Desk's CCCs. A Hub Desk would thereby be able to maintain sufficient inventory to meet HSBC's client demand, whether from direct third-party clients or arising from Local Sales Desk client activity, allowing the Hub Desk to efficiently manage HSBC's aggregated risk.

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Thank you for your attention to HSBC's comments on the Proposal. We would welcome the opportunity to provide any additional information that the Agencies may consider helpful.

Sincerely,

A handwritten signature in blue ink, appearing to read "Mark R. Hutchinson".

Mark R. Hutchinson

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