



THE FINANCIAL SERVICES ROUNDTABLE

*Financing America's Economy*



Building Success. Together.

February 13, 2012

Re: Comment Letter on the Notice of Proposed Rulemaking Implementing the Volcker Rule – Proprietary Trading

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association, the American Bankers Association, the Financial Services Roundtable and the Clearing House Association<sup>1</sup> appreciate the opportunity to comment on the proprietary trading provisions of the proposed rules (the “**Proposal**”) implementing new Section 13 of the Bank Holding Company Act of 1956 (the “**Volcker Rule**”). The Proposal was issued by the Agencies<sup>2</sup> in two notices of proposed rulemaking.<sup>3</sup>

**The Importance of Protecting Financial Markets While Implementing the Volcker Rule.** The Proposal clearly evidences the Agencies’ thoughtfulness and dedication in seeking to implement the statutory Volcker Rule. It contains many useful elements that show the Agencies’ careful analysis of the statutory provisions, and the questions posed demonstrate the Agencies’ open-mindedness and commitment to implementing the statute.

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<sup>1</sup> Further information about the signatories is available in Annex C.

<sup>2</sup> The Agencies are the Office of the Comptroller of the Currency (the “**OCC**”), the Board of Governors of the Federal Reserve System (the “**Board**”), the Federal Deposit Insurance Corporation (the “**FDIC**”), the Securities and Exchange Commission (the “**SEC**”) and the Commodity Futures Trading Commission (the “**CFTC**”). The respective rule identifiers are Docket No. R-1432, RIN 7100-AD82 (Board); RIN 3064-AD85 (FDIC); Docket No. OCC-2011-0014, RIN 1557-AD44 (OCC); File Number S7-41-11, RIN 3235-AL07 (SEC); and RIN 3038-AC[ ] (CFTC).

<sup>3</sup> Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011) (the “**Proposal**”); Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds (proposed Jan. 13, 2012).

However, as stated in the Financial Stability Oversight Council (“**FSOC**”) Study, there is a delicate balance to be struck in proscribing proprietary trading while protecting financial markets and market participants,<sup>4</sup> and the current Proposal fails to strike that balance. To avoid damaging the U.S. markets, the Proposal should be revised as described in this letter.

We believe that Congress’ goal in adopting the statutory Volcker Rule was to focus banking entities on providing liquidity to customers and to prohibit excessive risk taking beyond that required for customer activity. The Proposal, however, defines permitted activities far too narrowly and subjects banking entities to a conceptually difficult and operationally expensive set of requirements, the costs of which cannot be justified based on their benefits. These requirements may paralyze effective market making, which is far from the statute’s intent. In addition, as an unintended and deleterious side effect, the Proposal will severely limit banking entities’ ability to hedge their own risk, thereby increasing rather than decreasing the risk to banking entities and the financial system.

The potential costs to the financial markets, investors and corporate issuers from incorrectly implementing the Volcker Rule are enormous.<sup>5</sup> Many commenters, including customers, buy-side market participants, industrial and manufacturing businesses, treasurers of public companies and foreign regulators—constituencies with different goals and interests—have agreed that the Proposal would significantly harm financial markets. They point to the negative impacts of decreased liquidity, higher costs for issuers, reduced returns on investments and increased risk to corporations wishing to hedge their commercial activities. Commenters from each of these groups have made the case that other market participants are unlikely to be able to fill the critical role played by the customer-oriented principal activities of banking entities. We agree with AllianceBernstein that “the inability to confidently engage in market making activities on a principal basis under the Proposal, along with the onerous recordkeeping and compliance burdens required will have a material and detrimental impact on the ability of covered banking entities to engage in market making activity [and] will dramatically reduce market liquidity, increase costs and in some cases impact the ability of

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<sup>4</sup> See FSOC Report, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds 1 (Jan. 18, 2011) (“**FSOC Study**”).

<sup>5</sup> For example, in a study commissioned by SIFMA, Oliver Wyman has estimated the impact on issuers and investors of a loss of liquidity possibly resulting from the Proposal. Oliver Wyman found that liquidity losses could cost investors between \$90 billion and \$315 billion in mark-to-market losses on the value of their existing holdings; cost corporate issuers between \$12 billion and \$43 billion per year in borrowing costs; and cost investors between \$1 billion and \$4 billion per year in transaction costs as the level and depth of liquidity decreases. Oliver Wyman, *The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity* (Feb. 2012) (“**Oliver Wyman 2012 Study**”). See also Darrell Duffie, Stanford University, *Market Making Under the Proposed Volcker Rule* (Jan. 16, 2012) (“**Duffie Analysis**”), at 3 (concluding that the “direct and indirect effects” of the Proposal “would increase trading costs for investors, reduce the resiliency of markets, reduce the quality of information revealed through security prices, and increase the interest expense and capital-raising costs of corporations, individuals, and others,” and explaining that “[t]hese outcomes would lead to somewhat lower expected economic growth” having “potential adverse consequences for systemic risk”).

market participants to meet their legally required obligations to investors and other stakeholders.”<sup>6</sup>

We do not think that these consequences were the Agencies’ intention. We believe that the Agencies, like Congress, wish to allow banking entities to provide corporations and investors liquidity in financial instruments by intermediating between market participants over time and in size—the essential function of market makers.

**Our Key Conceptual Concerns with the Proposal’s Approach.** In Annex A, we describe the problems we see with the Proposal and the ways in which we believe it could be reoriented to better achieve congressional intent. We believe, however, that there are a number of problematic themes that permeate the Proposal.

***Artificial Distinction Between Permitted Activities and Proprietary Trading.*** The Proposal attempts to draw a bright dividing line between permitted activities and prohibited short-term proprietary trading. We believe that drawing such a line is not only unnecessary and impractical, but also is inconsistent with the structure of the statutory Volcker Rule. Congress allowed the permitted activities *regardless* of the fact that they are short-term proprietary trading. Therefore, the Agencies’ attempt to define the permitted activities as distinct from proprietary activities is inconsistent with congressional intent and doomed to failure. It results in an overly narrow interpretation of the permitted activities that constrains the beneficial effects those activities have for corporate issuers and investors that rely on the capital markets.

***Negative Presumptions and Reliance on Hard-Coded Criteria.*** The Agencies’ focus on prohibited behavior, at the cost of overly restricting permitted activities, is expressed in the negative presumptions that permeate the Proposal. Throughout the Proposal, the Agencies assume that activities are prohibited unless proven otherwise. We believe that this negative presumption is inconsistent with explicit congressional intent to allow useful principal activity. We believe it is also inconsistent with the historical approach that the Agencies have taken in supervising banking entities, which would have formed Congress’ expectation of how the Volcker Rule would be implemented. We believe that the numerous letters to the Agencies from members of Congress, as well as the recent House Financial Services Committee hearing on the Proposal, indicate Congress’ surprise and concern at the path the Agencies have taken.

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<sup>6</sup> Letter from AllianceBernstein L.P. to the Agencies (Nov. 16, 2011). *See also* Duffie Analysis at 3 (noting that “the Agencies’ proposed implementation of the Volcker Rule would reduce the quality and capacity of market making services that banks provide to U.S. investors” and that “investors and issuers of securities would find it more costly to borrow, raise capital, invest, hedge risks, and obtain liquidity for their existing positions”); Oliver Wyman 2012 Study at 2 (concluding that the Proposal “could significantly impair liquidity provided by market makers”).

The negative presumption manifests itself most clearly in the Agencies' reliance on hard-coded criteria to define the permitted activities, under which the failure to meet any single criterion disqualifies the trading unit from engaging in the permitted activity. Such an approach shoehorns all permitted activity into one or a few archetypes, rather than reflecting the numerous ways market participants engage in beneficial activities that Congress meant to protect. Even more unfortunately, the archetype chosen by the Agencies does not represent the majority of the markets, but rather is reflective of a small portion of transactions in one type of liquid market. For example, the heavy reliance on bid-ask spreads, and the presumption that revenues that deviate from bid-ask spreads are indicative of prohibited proprietary trading, are at odds with the fact that few markets have a readily determinable bid-ask spread that is quantifiable or that could sustain a market-making business. As a result, in order to rebalance the proprietary trading proscription with the permitted activities, we believe that the hard-coded criteria should be removed from the rule and, subject to our specific recommendations and to the extent relevant, incorporated into the final Volcker Rule regulations as guidance.

***Transaction-by-Transaction Approach.*** We believe that the Proposal's transaction-by-transaction approach to principal trading is symptomatic of the focus on proscribing proprietary trading and is inconsistent with the intent of a statute that broadly speaks of permitted "activities." We believe that an analysis that seeks to characterize specific transactions as either market making, hedging, underwriting or another type of permitted or prohibited activity does not accord with the way in which modern trading units operate, which generally view individual positions as a bundle of characteristics that contribute to their complete portfolio. We believe that analyzing permitted activities on a transaction-by-transaction basis will not only be unsuccessful but will also, in the process, harm legitimate activity in financial markets.

***Overly Specific and Prescriptive Compliance Regime.*** Finally, we believe that the Proposal's compliance regime is overly specific, prescriptive and impractical. We believe this arises from trying to develop a scheme that identifies each and every possible instance of prohibited proprietary trading in an otherwise permitted activity. We believe the effect, instead, will be to make some activities so impractical for banking entities that they can no longer be cost-justified. For example, the strict dichotomy in the Proposal between customer trades and non-customer trades would seem to require banking entities to tag each and every trade as to whether the counterparty qualifies as a customer at that particular time for that particular trade. We believe that, instead, the Agencies should institute a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations. The Agencies should permit banking entities to leverage existing compliance regimes, including the use of existing board-level governance protocols.

***Our Suggestion for Reorienting the Proposal.*** We believe that there is a better way—that the Proposal can be reoriented to avoid much of this negative impact. We

believe that the Agencies should reorient the Proposal to bring it closer to congressional intent regarding the Volcker Rule. Rather than seeking to scrutinize every transaction in search of possible prohibited proprietary trading, the Proposal should protect the ability of banking entities to engage in the critical financial intermediation explicitly permitted by Congress.

We agree that Congress intended, and the Agencies should require, banking entities to eliminate pure proprietary trading businesses. However, banking entities should be allowed to engage in customer-focused principal trading under the statutorily permitted activities. To foster customer-oriented business, the Agencies' hard-coded criteria should be recast as guidance that helps banking entities to differentiate client-focused business from other business. We believe a business should be viewed as customer-focused, and therefore engaged in market making, if it is oriented to meeting customer demand throughout market cycles. The Agencies' guidance should explicitly recognize that maintaining a customer focus not only requires a commitment to buy from and sell to customers, but also requires obtaining positions in anticipation of customer flow and trading in the interdealer market in order to validate liquidity, volatility, pricing and other market trends.<sup>7</sup>

This guidance would be incorporated in policies and procedures by the banking entities, with risk limits and controls monitored by the Agencies through examinations. Certain quantitative metrics, measured at a level within the organization that permits activities to be viewed as a whole, may help highlight certain activities that could be discussed with examiners and in the context of horizontal reviews. As suggested in the Proposal, however, metrics should not be used as a bright-line trigger for remedial action. Some metrics may be more relevant than others, depending upon the particular asset class, activity, particular market, and unique characteristics of each banking entity. Over time, based on discussions with examiners, the banking entities and examiners would determine the usefulness and relevance of individual metrics.<sup>8</sup> We believe this reorientation would ensure that covered banking entities avoid prohibited speculative activity while preserving deep and liquid financial markets.

***Phase-In.*** We believe that the implementation of the Volcker Rule should be phased in over time to minimize disruption to the financial markets and to gain experience with the development of a compliance program and the relevance of metrics. First, the Agencies should clarify that banking entities will have the full two-year statutory conformance period after release of a final rule to end noncompliant activities and build necessary compliance systems. After the statutory conformance period, and any discretionary extensions the Agencies deem prudent to provide, the Agencies should first apply the final

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<sup>7</sup> As such, as discussed beginning on page A-44 below, we strongly believe that interdealer trading activities are critical to market making.

<sup>8</sup> Given the current timing of the Proposal, we are concerned that a limited conformance period may make it difficult to implement the compliance program in time, and if the final rule does not remedy this, we believe that certain risk management metrics would be the most critical to implement first.

Volcker Rule regulations to covered banking activities in the United States. The regulations should be phased in by asset class or line of business. This approach will allow the Agencies to learn from the experience of phasing in the regulations for particular businesses in the United States. The Agencies will be able to address interpretative questions that will arise, gauge market reaction and make appropriate changes before applying the regulations to the full range of asset classes and activities outside the United States, where further complications are bound to arise.

***Coordinated Regulation.*** Neither the statutory Volcker Rule nor the Proposal makes clear how the five Agencies will coordinate interpretation, examination and enforcement of the Volcker Rule regulations.<sup>9</sup> This “supervisory confusion” could lead to five different sets of interpretations, examinations and enforcement, which would make it impossible for covered banking entities to undertake their key role in financial markets. We believe that the Agencies should provide in the final rules that: (i) the Board will have exclusive authority to interpret the Volcker Rule and the final rules; (ii) where more than one Agency has examination authority over a given banking entity, the appropriate Agencies will engage in a coordinated examination of such banking entity under the Volcker Rule; and (iii) an enforcement action under the Volcker Rule may be initiated by an Agency only in consultation with the other Agencies, if any, that participated in the coordinated examination process with respect to the banking entity that is the subject of the action.

***Extraterritorial Scope.*** We also recognize that the extraterritorial scope of the Proposal is problematic in a number of ways. We understand that other comment letters are discussing these issues and we have therefore concentrated this letter on other aspects of the Proposal.

***Request for Reproposal.*** We believe it would be prudent for the Agencies to repropose the Volcker Rule.

First, the changes to the Proposal needed to correctly implement the Volcker Rule mandate and to avoid serious harm to our financial markets are so extensive that reproposal will be required as a matter of administrative law. Commenters will not have a legally sufficient opportunity to comment on the final rule without a further opportunity to review the necessary changes.

Second, in posing more than 1,300 questions, the Agencies have revealed the wide array of open issues in the Proposal. The Agencies will receive possibly hundreds of comment letters from banking entities, asset managers, business groups, American corporations, members of Congress, former U.S. regulators, foreign regulators and others that will provide numerous suggestions and explain to the Agencies the unintended consequences of elements of the Proposal. Incorporating these comments into an already complex and

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<sup>9</sup> The CFTC explicitly asked about supervisory coordination in Question 8.1 of its proposal.

flawed rule may lead to further unintended consequences and is likely to result in a proposal sufficiently different that market comment would be useful to the Agencies.

Third, the stakes for our already stressed financial markets are high. To minimize sudden detrimental impacts to existing businesses, and negative impacts to the U.S. economy and, indeed, to retail investors and consumers, the recrafting of the rule must be performed in a nuanced and iterative way. These impacts require dialogue with foreign sovereigns, Congress and other regulators.

Finally, the industry and the public have not yet seen a comprehensive cost-benefit analysis of the Proposal. Given the far-reaching direct and indirect effects on capital formation, cost of assets and services, liquidity of markets and viability of customer relationships, the opportunity to review and comment on a cost-benefit analysis is essential.

**Our Specific Responses to the Agencies' Questions.** Annex A provides specific responses to the Agencies' questions in the Proposal and our concrete suggestions for changes. Annex B provides a chart that lists each of our main points and the questions in the Proposal to which we believe they apply.<sup>10</sup>

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We thank the Agencies for their consideration of our comments. If you have any questions, please do not hesitate to call Kenneth E. Bentsen, Executive Vice President, Public Policy and Advocacy, SIFMA at 202-962-7400; Randolph C. Snook, Executive Vice President, SIFMA at 212-313-1114; our counsel, Robert L.D. Colby, Davis Polk & Wardwell LLP, at 202-962-7121 and Margaret E. Tahyar, Davis Polk & Wardwell LLP, at 212-450-4379; or any of the organizations listed below.

Sincerely,  
Securities Industry and Financial Markets Association  
American Bankers Association  
Financial Services Roundtable  
The Clearing House Association

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<sup>10</sup> We also refer to the letters submitted by SIFMA on the subjects of securitization (Feb. 13, 2012) (available at <http://www.sifma.org/issues/item.aspx?id=8589937357>), municipal obligations (Feb. 13, 2012) (available at <http://www.sifma.org/issues/item.aspx?id=8589937356>), and the impact of the proposed market making requirements on asset managers (Feb. 13, 2012) (available at <http://www.sifma.org/issues/item.aspx?id=8589937354>), as well as the letter on the treatment of covered funds, written jointly by SIFMA, the ABA, the Roundtable and The Clearing House (Feb. 13, 2012) (“**Joint Covered Funds Letter**”) (available at <http://www.sifma.org/issues/item.aspx?id=8589937355>).

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## RECOMMENDATIONS AND OBSERVATIONS

This Annex is divided into key topics in the Proposal. Each topic begins with a summary of our key points. Each point is then discussed in greater detail.

### I. Covered Financial Position and Trading Account

#### A. *Purpose Test*

The proposed definition of “trading account” exceeds statutory authority and should be limited to the purpose test.

#### B. *Negative Presumptions*

The “trading account” definition, and the Proposal more generally, should be changed to remove implicit negative presumptions.

#### C. *Definition of Derivative*

The Agencies should narrow the definition of “derivative” to avoid including in the “covered financial position” definition instruments that should not be part of the Volcker Rule proprietary trading restrictions.

#### D. *Market Risk Capital Rule Test*

The Agencies should eliminate the “Market Risk Capital Rule test” or, in the alternative, treat it as a nonexclusive indicative factor rather than as a dispositive test.

#### E. *Status Test*

The Agencies should eliminate the “status test” or, at most, treat the status test as a nonexclusive indicative factor rather than as a dispositive test.

#### F. *Sixty-Day Holding Period Presumption*

The Agencies should refashion the sixty-day holding period presumption and include it as guidance rather than as a hard-coded rule.

#### G. *Variation Margin*

Daily variation margin should not be viewed as an indicator of short-term proprietary trading intent.

### II. Market Making-Related Permitted Activity

#### A. *Effects of Narrow Market Making-Related Permitted Activity*

The Agencies’ approach to the market making-related permitted activity would have significant deleterious real-world effects on the financial markets and on the investors and customers that rely on such markets for liquidity.

**B. *Customer-Focused Market Making-Related Activities***

The Agencies' approach to market making should be replaced by one in which trading units are allowed to engage in customer-focused market making-related activities.

**C. *Hard-Coded Factors***

The hard-coded factors in the Proposal's rule should be removed from the rule itself and become principles-based guidance for reasonably designed policies and procedures. The Agencies should receive information from quantitative metrics, policies and procedures and examinations to oversee the system.

**D. *Differences in Market Making Between Markets***

In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in *any* market, even the most liquid equity markets.

**E. *Market Making vs. Market Making-Related Activity***

The hard-coded set of criteria appears to reduce the permitted activity to "market making," rather than "market making-related," activity, contrary to congressional intent.

**F. *Sources of Revenue***

The Agencies should not require, even in guidance, that market making-related permitted activities be "designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income." This formulation exceeds statutory intent, prejudices appropriate results for revenue metrics and ignores the fact that, frequently, a *bona fide* market maker may not be able to provide market making services unless it can benefit from revenues from market movements.

**G. *Transaction-by-Transaction Approach***

The Agencies should not analyze the market making-related permitted activity on a transaction-by-transaction basis.

**H. *The Role of Market Makers as Intermediaries***

The regulations implementing the market making-related permitted activity should reflect the role of market makers as intermediaries between market participants in different physical locations, at different times and in different sizes.

**I. *Holding Oneself Out as a Market Maker***

The Proposal's discussion of what constitutes a market maker "hold[ing] itself out as being willing to buy and sell . . . on a regular or continuous basis" is too narrow to reflect market making in the vast majority of markets.

**J. *Block Positioners***

The interpretation of "block positioner" should be expanded to address the differences between asset classes.

**K. *Reasonably Expected Near-Term Demands of Clients***

The proposed guidance around the "reasonably expected near term demands of clients, customers or counterparties" requirement misconstrues the statutory

requirement and does not adequately allow market makers to build and maintain necessary inventory.

***L. Interdealer Market Making-Related Activities***

The Agencies should expressly include interdealer market making-related activities within the permitted activity.

***M. New or Bespoke Products***

The Agencies should ensure that banking entities can be market makers in new or bespoke products, including structured products and transactions driven by customer requests.

***N. Dealer Registration Requirement***

The Agencies should remove the requirement that a market maker be registered as a dealer or subject to substantive regulation.

***O. Arbitrage Activities***

The market making-related permitted activity should recognize that arbitrage activities, as the Agencies understand them, can constitute market making-related activities.

***P. Foreign Sovereign Debt***

If foreign sovereign debt is not excluded from the Volcker Rule restrictions, the Agencies must ensure that operations of banking entities in foreign jurisdictions are allowed to meet that jurisdiction's primary dealer and other requirements.

***Q. Exchange-Traded Funds***

The Agencies should clarify that banking entities can make markets in, and be Authorized Participants for, exchange-traded funds.

***R. Market Making-Related Hedging***

Market making-related hedging should not be subject to the risk-mitigating hedging requirements as long as the hedge positions are designed to mitigate the risk of positions acquired through permitted market making-related activities.

**III. Underwriting Permitted Activity**

***A. In Connection with a Distribution***

The word "solely" should be removed from the "in connection with a distribution" prong of the underwriting permitted activity.

***B. Near-Term Demands of Clients***

The Agencies should interpret the "near term demands of clients" prong flexibly to accommodate capital formation.

***C. Focus on Regulation M Distributions***

The focus on Regulation M distributions in the definition of underwriting would preclude certain *bona fide* underwriting activities. The definition of distribution should be expanded to not require "magnitude" and to explicitly include any offering of securities by an issuer and any offering by a selling shareholder that is

registered under the Securities Act or that involves an offering document prepared by the issuer.

***D. Bridge Loans***

The Agencies should provide greater clarity around the treatment of securities issued in lieu of or to refinance bridge loans.

***E. Current Market Practices***

The Agencies should expand the definition of underwriter to reflect current market practices.

**IV. Risk-Mitigating Hedging Permitted Activity**

***A. General Approach to Risk-Mitigating Hedging***

The permitted activity should consist of a general statement that risk-mitigating hedging is permitted and encouraged, with the current hard-coded criteria moved to become guidance and a requirement that banking entities adopt risk limits and policies and procedures commensurate with the Agencies' guidance. The Agencies would review risk-mitigating hedging through metrics and examinations.

***B. Non-Market Making-Related Hedging***

The permitted activity should focus on non-market making-related hedging, leaving market making-related hedging to the market making-related permitted activity.

***C. Reasonable Correlation***

Requiring that a hedging position be "reasonably correlated" to the risk hedged, rather than including correlation as one indicator of hedging activity, could limit valid risk-mitigating hedging activities.

***D. No New Significant Risks at Inception***

The "no new significant risks at inception" requirement does not appear to recognize that all hedging activity subjects the banking entity to new, possibly significant risks. Instead, the guidance should incorporate the Agencies' idea that basis and credit risks, among other risks, may occur as part of valid hedging.

***E. Choice of Hedging Strategy***

The Agencies should confirm that banking entities may choose to use any hedging strategy that meets the requirements of the risk-mitigating hedging permitted activity, and do not have to choose the "best hedge" along any specific dimension.

***F. Anticipatory Hedging***

Permitted anticipatory hedging should be explicitly allowed and should not be limited to "slightly" before a risk is taken.

***G. Continuing Review Requirements***

The continuing review requirements should focus on the overall portfolio of a trading unit, rather than on individual hedges.

**H. *Coordinated Hedging***

Coordinated hedging through and by affiliates should be eligible for the risk-mitigating hedging permitted activity.

**I. *Cross-Level Documentation***

Policies and procedures are sufficient to address hedging at a level of the organization other than where the risk resides; additional documentation should only be required if a hedge put on two levels above the level of the risk goes beyond the hedging covered by the policies and procedures.

**V. *Government Obligations Permitted Activity***

**A. *Derivatives on Permitted Government Obligations***

The permitted activity should include trading in derivatives on permitted government obligations.

**B. *State and Municipal Agency Obligations***

The permitted activity should include trading in state and municipal agency and authority obligations.

**C. *Foreign Sovereign Debt***

The permitted activity should include trading in foreign sovereign debt of countries to the extent otherwise permitted by law.

**VI. *On Behalf of Customers Permitted Activity***

**A. *Narrowness of On Behalf of Customers Permitted Activity***

The permitted activity defines “on behalf of customers” too narrowly and should include, for example, transactions by a banking entity as principal to facilitate a customer need where the banking entity substantially hedges the resulting principal position.

**B. *Clearing-Related and Prime Brokerage Activities***

If clearing-related activities are not excluded from the trading account, customer clearing, as well as prime brokerage activities, should be explicitly included in the “on behalf of customers” permitted activity.

**VII. *Excluded Transactions***

**A. *Repurchase Agreements***

The exclusion from trading account for repurchase agreements is appropriate, but should be expanded to include transactions related to such agreements and should explicitly clarify that all types of repurchase transactions qualify for the exclusion.

**B. *Transactions Not Based on Expected or Anticipated Movements in Asset Prices***

Transactions “not based on expected or anticipated movements in asset prices,” such as fully collateralized swap transactions that serve funding purposes, should be exempted from the definition of trading account.

**C. *Securities Lending Transactions***

The exclusion from trading account for securities lending transactions is appropriate, but should be expanded to include transactions related to securities lending operations, such as transactions where a security is purchased to cover a short position or purchased or created in order to lend.

**D. *Debts Previously Contracted***

The Agencies should exclude activities related to assets received in satisfaction of debts previously contracted from the definition of “trading account.”

**E. *Clearing-Related Activities***

The Agencies should exclude a banking entity’s clearing-related activities from the “trading account” definition.

**F. *Asset Liability Management***

The exclusion from trading account for certain “liquidity management” activities should be expanded to include all positions used in liquidity and other asset-liability management activities.

**G. *Interaffiliate Transactions***

The Agencies should view interaffiliate transactions as part of a coordinated activity for purposes of determining whether a banking entity falls within a permitted activity rather than as separate transactions to which separate “trading account” analyses would apply.

**H. *Securitization***

The Proposal impermissibly restricts the statutory exemption for loan securitizations.

**VIII. Conflicts of Interest**

**A. *Disclosure***

The Agencies should confirm that “clear, timely and effective disclosure” can take the form of either periodic or specific disclosures regarding transactions.

**B. *Information Barriers***

The Agencies should confirm that a banking entity may conclusively rely on information barriers to avoid a “material conflict of interest.”

**C. *Asset-Backed Securities***

Conflicts of interests relating to asset-backed securities should be exempted by the Proposal and addressed solely through Section 621.

**IX. Foreign Exchange**

**A. *Application to Foreign Exchange Swaps and Forwards***

The Volcker Rule’s proprietary trading restrictions should not be applied to the well-functioning markets for foreign exchange swaps and forwards, which are integral to global payments and monetary policy and meet essential needs of a broad range of market participants, including small businesses and other end users.

**B. *Definition of Derivative***

The Agencies are not required to, and should not, include foreign exchange swaps and forwards in the definition of “derivative.”

**C. *Trading Account***

If the Agencies choose to include foreign exchange swaps and forwards within the definitions of “derivative” and “covered financial position,” transactions in these instruments should be excluded from a banking entity’s trading account.

**X. *Compliance and Quantitative Metrics***

**A. *Approach to Compliance and Metrics***

As the FSOC has suggested, the Agencies should implement the Volcker Rule through a combination of internal compliance policies and procedures, reporting and review of quantitative metrics and supervisory review.

**B. *Level of Trading Unit***

“Trading unit” should be defined at a level that presents its activities in the context of the whole. The appropriate level may differ depending on the structure of a banking entity.

**C. *Thresholds***

The Agencies should not impose thresholds for quantitative metrics but should use the metrics to highlight opportunities for further discussion.

**D. *Problematic Metrics***

The Agencies should not require the Spread Profit and Loss, VaR Exceedance, Comprehensive Profit and Loss Attribution and Pay-to-Receive Spread Ratio metrics.

**E. *Customer-Facing Trade Ratio***

The Customer-Facing Trade Ratio is flawed. Instead, the Agencies could require each institution to provide information on activities by class of counterparty.

**F. *Inventory Aging and Inventory Risk Turnover***

The Inventory Aging metric is only applicable to cash instruments and should not apply to derivatives. Additional changes to the Inventory Risk Turnover metric should be made to ensure it achieves its intended purpose.

**G. *Appendix C Compliance Regime***

The Appendix C compliance regime is overly specific, prescriptive and impractical. It should be replaced with a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations.

**H. *Leveraging Existing Compliance Regimes***

The Agencies should permit banking entities to leverage existing compliance regimes, including the level at which compliance is monitored, in order to minimize inefficiencies, unnecessary expense and the potential for conflicting compliance protocols, including the use of existing Board governance protocols.

## XI. **Supervisory Coordination**

### A. ***Coordination Between Regulators***

In order to avoid the confusion and costs of multiple overlapping regulators, we believe that the Agencies should provide in the final rules that: (i) the Board will have exclusive authority to interpret the Volcker Rule and the final rules; (ii) where more than one Agency has examination authority over a given banking entity, the appropriate Agencies will engage in a coordinated examination of such banking entity under the Volcker Rule; and (iii) an enforcement action under the Volcker Rule may be initiated by an Agency only in consultation with the other Agencies, if any, who participated in the coordinated examination process with respect to the banking entity that is the subject of the action.

## XII. **Phase-In and Effectiveness**

### A. ***Statutory Conformance Period***

Banking entities should have the full statutory conformance period to bring activities into compliance with the Volcker Rule. Banking entities should not be required to bring activities into compliance “as soon as practicable” after July 21, 2012.

### B. ***Metrics and Compliance***

Requiring banking entities to implement completely the metrics and compliance requirements by July 21, 2012 is inconsistent with the statutory Volcker Rule, is unrealistic and will be counterproductive.

### C. ***Phase-In***

After the conformance period, the Volcker Rule regulations should be phased in. Final regulations should first apply to the U.S. activities of banking entities and only later to foreign activities of banking entities. Within each of these categories, the regulations should be phased in by asset class or line of business.

## XIII. **Cost-Benefit Analysis**

### A. ***Need for Cost-Benefit Analysis***

The Agencies should conduct a rigorous cost-benefit analysis of the Proposal consistent with the principles laid out in the *Business Roundtable* decision.

### B. ***Costs Outweigh Benefits***

If the Agencies perform the sort of cost-benefit analysis contemplated in the *Business Roundtable* decision, we believe they will find that the costs of the Proposal substantially outweigh the benefits.

### C. ***Reproposal***

The Agencies should repropose the rule once they have conducted a meaningful cost-benefit analysis.



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## I. Covered Financial Position and Trading Account

### A. Purpose Test

**Recommendation:** The proposed definition of “trading account” exceeds statutory authority and should be limited to the purpose test.<sup>11</sup>

We believe that the “trading account” definition is overbroad, exceeding the Agencies’ statutory authority and congressional intent. We believe the “trading account” definition should be limited to the purpose test, which is the statutorily prescribed definition of a “trading account.”

The statutory text of the Volcker Rule defines “trading account” as “any account used for acquiring or taking positions in [covered financial positions] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)” and other accounts determined to be “trading accounts” by the Agencies.<sup>12</sup> The “purpose test” in the Proposal follows the statutory text closely, limiting itself to accounts used by a covered banking entity<sup>13</sup> to “acquire or take one or more covered financial positions principally for the purpose of: (1) short-term resale; (2) benefitting from actual or expected short-term price movements; (3) realizing short-term arbitrage profits; or (4) hedging one or more positions described [above].”<sup>14</sup> However, rather than simply applying this “purpose test,” the Agencies have added the “Market Risk Capital Rule test” and the “status test.” As discussed below,<sup>15</sup> these two additional tests exceed the statutory authority granted to the Agencies because they would include transactions that are not entered into with short-term intent. As we note below, the “Market Risk Capital Rule test” and “status test” should be deleted or, at most, applied as nonexclusive indicative factors of short-term proprietary trading intent.

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<sup>11</sup> We believe this section is responsive to Question 14 in the Proposal.

<sup>12</sup> Bank Holding Company Act § 13(h)(6) (as added by Dodd-Frank § 619).

<sup>13</sup> For the remainder of this letter, we refer to “covered banking entities” as “banking entities.”

<sup>14</sup> Proposal § \_\_.3(b)(2)(i)(A).

<sup>15</sup> See the discussion of the Market Risk Capital Rule test, beginning on page A-16, and the discussion of the status test, beginning on page A-18.

## B. Negative Presumptions

**Recommendation:** The “trading account” definition, and the Proposal more generally, should be changed to remove implicit negative presumptions.<sup>16</sup>

The “trading account” definition evidences the Proposal’s overall approach of treating all short-term principal activity as banned unless explicitly permitted—what has been referred to as the Proposal’s “negative presumption.” The overly inclusive “trading account” definition sweeps the vast majority of a banking entity’s activities into the trading account, requiring that the banking entity find specific approval to engage in them. This general approach is repeated throughout the Proposal. For example, rather than generally allowing banking entities to engage in “permitted activities” such as market making and hedging with guidance on the bounds of what is allowed as part of those activities, the Agencies presume that any trading account activity is impermissible, even if it is part of market making or hedging, unless very rigid requirements are met.

Since the “trading account” definition serves as the cornerstone for any Volcker Rule analysis and the guidepost of the Agencies’ interpretation of the statutory restrictions, we believe it is important to reverse the negative presumption in the “trading account” definition.

Through the Proposal’s negative presumptions, the Agencies will chill legitimate activity. Banking entities may avoid activities that are and should be allowed, but that may give rise to worries about their ability to rebut the negative presumption. While other market participants may expand their roles over time,<sup>17</sup> providing ongoing liquidity requires capital that market participants, such as hedge funds, that are unaffiliated with banking entities may not be willing to dedicate to fully serve customer needs. In fact, 17 of the 21 primary dealers in U.S. government securities would be “banking entities” subject to the Proposal.<sup>18</sup> As a result, we believe that the *de facto* presumption that all principal activity by banking entities is prohibited unless it fits into narrow exclusions or permitted activities should be replaced by a broad understanding of what constitutes permitted activities that are bolstered by policies and procedures and quantitative metrics.

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<sup>16</sup> We believe this section is responsive to Question 14 in the Proposal.

<sup>17</sup> Duffie Analysis at 3 (“Eventually, non-bank providers of market-making services would fill some of the resulting void in market making capacity, but with an unpredictable impact on the safety and soundness of financial markets.”); Oliver Wyman 2012 Study, at 3 (“While non-bank market participants . . . could eventually assume the principal-based market making activities currently provided by banking entities, any such transition would likely take years to achieve” and “would be costly and disruptive in the near term.”).

<sup>18</sup> Oliver Wyman, *The Volcker Rule: Considerations for Implementation of Proprietary Trading Regulations* (Jan. 2011), at 10.

## C. Definition of Derivative

**Recommendation:** The Agencies should narrow the definition of “derivative” to avoid including in the “covered financial position” definition instruments that should not be part of the Volcker Rule proprietary trading restrictions.<sup>19</sup>

The statutory Volcker Rule restricts proprietary trading in securities, futures<sup>20</sup> and derivatives. The Agencies have termed these three types of instruments “covered financial positions” in the Proposal.<sup>21</sup> In defining “covered financial position,” the Agencies have relied on well-established and understood definitions of “security”<sup>22</sup> and “contract of sale of a commodity for future delivery.”<sup>23</sup> “Derivative” is not defined in the statutory Volcker Rule.

The Agencies’ definition of “derivative” begins with the Dodd-Frank definition of “swap” and “security-based swap,” as the SEC and CFTC further define them through joint rulemaking.<sup>24</sup> The definition also explicitly excludes financial instruments that the SEC and CFTC jointly determine are excluded from the definition of “swap” and “security-based swap.” The SEC and CFTC have proposed their definitional rule but have not yet finalized it.<sup>25</sup> It is inappropriate and inconsistent with the Administrative Procedure Act for a proposed rule to incorporate another proposed rule that will not be adopted as part of an integrated approval process where the comments on the proposals will be considered conjunctively.<sup>26</sup>

A key term in the proposed rule is undefined and its meaning will remain unsettled until the SEC and CFTC issue a final rule concerning the meaning of “swap” and “security-based swap.” This impedes the ability of commenters to provide input on the

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<sup>19</sup> We believe this section is responsive to Questions 46, 47, 48 and 54 in the Proposal.

<sup>20</sup> Including options on futures.

<sup>21</sup> See Proposal § \_\_.3(b)(3)(i).

<sup>22</sup> In particular, the definition of “security” in Section 3(a)(10) of the Exchange Act (15 U.S.C. § 78c(a)(55)). Proposal § \_\_.2(w).

<sup>23</sup> In particular, the definition of these terms under Section 1a of the Commodity Exchange Act (7 U.S.C. § 1(a)). Proposal § \_\_.3(c)(2).

<sup>24</sup> See Proposal § \_\_.2(l)(i)(A), incorporating the definitions under 7 U.S.C. § 1a(47) (as amended by Dodd-Frank § 721) and 15 U.S.C. § 78c(68) (as amended by Dodd-Frank § 761).

<sup>25</sup> See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818 (proposed May 23, 2011).

<sup>26</sup> We raise similar concerns related to inclusion of the proposed Market Risk Capital Rules, see the discussion beginning on page A-16, and the definitions of “swap dealer” and “security-based swap dealer,” see the discussion beginning on page A-18.

proposed Volcker Rule regulations given that their scope is unknown and contingent upon a separate rulemaking. As a result, we believe that the Agencies should not define “derivative” by reference to the SEC and CFTC’s definitional rule until the rule is finalized and the SEC and CFTC have had the opportunity to consider initial interpretative issues that might arise, and the public is afforded the opportunity to comment on the final definitions in connection with this rulemaking.

In addition to swaps and security-based swaps, the Agencies’ definition of “derivative” includes a number of instruments that Congress explicitly excluded from the definition of “swap” and “security-based swap.” In doing so, we believe that the Agencies have created a definition of “derivative” that incorporates instruments that do not belong within the scope of the Volcker Rule, have exceeded their congressional mandate and threaten to harm markets that Congress, through the exclusions from the statutory definitions, sought to protect. For example, the Proposal includes within the definition of “derivative” purchases or sales of nonfinancial commodities for deferred shipment or delivery that are intended to be physically settled.<sup>27</sup> Such transactions are not appropriately seen as “derivatives,” but instead as contracts for purchase of specific commodities to be delivered at a future date.<sup>28</sup> In recognition of this fact, Congress explicitly excluded these contracts from regulation as swaps.<sup>29</sup> We believe that this evidences congressional intent to protect this critical market, through which end users obtain commodities for production and hedging purposes.

In addition, although the Dodd-Frank Act explicitly provides the Treasury Secretary with the ability to exclude foreign exchange swaps and forwards from regulation as swaps for most purposes,<sup>30</sup> which the Treasury Secretary has proposed to do,<sup>31</sup> the Proposal explicitly includes foreign exchange swaps and forwards in the definition of “derivative” regardless of whether the Treasury Secretary makes such a determination.<sup>32</sup> We believe that this exceeds statutory intent regarding the regulation of these instruments. We discuss this issue further below.<sup>33</sup>

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<sup>27</sup> See Proposal § \_\_.2(l).

<sup>28</sup> Similarly, as these are not “other securit[ies] or financial instrument[s],” the Agencies do not have authority to expand the definition of covered financial position to include them. Bank Holding Company Act § 13(h)(4) (as added by Dodd-Frank § 619).

<sup>29</sup> See 7 U.S.C. § 1a(47) (as amended by Dodd-Frank § 721).

<sup>30</sup> The Treasury Secretary may not exclude foreign exchange swaps and forwards from regulation as swaps for swap data repository trade reporting requirements and a number of business conduct / antimanipulation standards. See 7 U.S.C. § 1a(47)(E)(iii)-(iv) (as amended by Dodd-Frank § 721). The statutory authority does not mention the Volcker Rule.

<sup>31</sup> See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25,774 (proposed May 5, 2011).

<sup>32</sup> See Proposal § \_\_.2(l)(i)(c).

<sup>33</sup> See the discussion beginning on page A-97.

## D. Market Risk Capital Rule Test

**Recommendation:** The Agencies should eliminate the “Market Risk Capital Rule test” or, in the alternative, treat it as a nonexclusive indicative factor rather than as a dispositive test.<sup>34</sup>

The “Market Risk Capital Rule test” requires that a banking entity treat as a trading account any account “used to acquire or take one or more covered financial positions, other than positions that are foreign exchange derivatives, commodity derivatives, or contracts of sale of a commodity for future delivery, that are Market Risk Capital Rule covered positions, if the banking entity, or any affiliate of the banking entity that is a bank holding company, calculates risk-based capital ratios under the Market Risk Capital Rule.”<sup>35</sup> As stated above, we believe that any test that goes beyond the statutory “purpose test” is beyond the scope of statutory authority and congressional intent.<sup>36</sup> As a result, we believe that Agencies should eliminate the “Market Risk Capital Rule test” or, at most, treat it as a nonexclusive indicative factor rather than as a dispositive test.

While the Agencies justify inclusion of the “Market Risk Capital Rule test” by stating that the Market Risk Capital Rule uses substantially similar language to the purpose test, we believe that the different contexts under which the two formulations arise mean that there are Market Risk Capital Rule positions that would not satisfy the “purpose test” under the Volcker Rule regulations. In particular, the requirement under the Basel capital rules to categorize every asset in either the “Trading Book” or the “Banking Book” can lead to situations in which positions categorized in the Trading Book may not be for short-term purposes, such as term derivatives.<sup>37</sup> As a result, using the Market Risk Capital Rule test reinforces the negative presumption that large swaths of a banking entity’s business are prohibited proprietary trading unless proven otherwise, and could capture within the trading account definition instruments Congress did not intend to include.

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<sup>34</sup> We believe this section is responsive to Questions 14, 15 and 16 in the Proposal.

<sup>35</sup> Proposal § \_\_.3(b)(2)(i)(B).

<sup>36</sup> See the discussion beginning on page A-12.

<sup>37</sup> The Agencies note that the Market Risk Capital Rule in its current form defines “covered position” to include any position in a bank’s “trading account,” which is defined to include “regularly underwriting or dealing in securities; interest rate, foreign exchange rate, commodity, equity, and credit derivative contracts; other financial instruments; and other assets for resale . . . and . . . acquiring or taking positions in such items as an accommodation to customers or for other trading purposes’ [and thus] includes trading positions that fall outside the statutory ‘trading account’ for purposes of determining what is prohibited and permitted covered trading activity under section 13 of the BHC Act.” Proposal at 68,858 & n.99 (Board Proposal (“FRB”) page 30 & n.99).



In addition, we believe that the Market Risk Capital Rule should not be incorporated into the Proposal, even as a nonexclusive indicative factor, until it is finalized. The Agencies have not incorporated the current Market Risk Capital Rule into the Proposal, but instead have incorporated a new, recently proposed version.<sup>38</sup> This is, in part, because the current Market Risk Capital Rule would include many positions that are not entered into with short-term intent, such as certain positions in long-dated derivatives or derivative transactions entered into in connection with asset-liability management activities.<sup>39</sup> Since the new Market Risk Capital Rule is only proposed, however, it is unclear whether all such positions will be appropriately excluded from the rule when finalized. As stated above,<sup>40</sup> we believe it is inappropriate and inconsistent with the Administrative Procedure Act for a proposed rule to incorporate another proposed rule that will not be adopted as part of an integrated approval process where the comments on the proposals will be considered conjunctively. Basing the trading account definition on a proposed, rather than finalized, Market Risk Capital Rule, which will be considered by a separate process of the Basel Committee on Banking Supervision, makes it impossible for our members to adequately consider and comment on the effect that the test might have, particularly in light of the myriad other issues posed by the Proposal.

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<sup>38</sup> See Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1,890 (proposed Jan. 11, 2011). The Agencies note that the “Market Risk Capital Rule test” is proposed “in contemplation of the proposed revisions to the Market Risk Capital Rules and, in particular, the proposed definition of ‘covered position’ under those proposed revisions.” Proposal at 68,859 (FRB 32).

<sup>39</sup> The Agencies note that “under the proposed revisions to the Market Risk Capital Rules, but not the existing Market Risk Capital Rule, the term ‘covered position’ expressly includes . . . only positions taken with short-term trading intent. The Agencies do not intend to incorporate ‘covered positions’ under the Market Risk Capital Rules in a way that includes positions lacking short-term trading intent.” Proposal at 68,859 n.105 (FRB 32 n.105). The current Market Risk Capital rules incorporate the definition of “trading account” from the instructions to the Board’s form FR Y-9C, which define “trading activities” as including “(a) regularly underwriting or dealing in securities; interest rate, foreign exchange rate, commodity, equity, and credit derivative contracts; other financial instruments; and other assets for resale, (b) acquiring or taking positions in such items principally for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements, and (c) acquiring or taking positions in such items as an accommodation to customers or for other trading purposes.” Instructions for Preparation of Consolidated Financial Statements for Bank Holding Companies at GL-77, Reporting Form FR Y-9C (Mar. 2007). In addition, the Form FR Y-9C definition of “trading account” captures any securities to which a banking entity applies fair value accounting. *Id.*

<sup>40</sup> See the discussion beginning on page A-14.

## E. Status Test

**Recommendation:** The Agencies should eliminate the “status test” or, at most, treat the status test as a nonexclusive indicative factor rather than as a dispositive test.<sup>41</sup>

Under the “status test,” a transaction is considered to be a trading account position if it is entered into by a banking entity that is a registered broker-dealer, municipal securities dealer, government securities dealer, swap dealer or security-based swap dealer to the extent that the position is taken in connection with the activities that require registration. The status test also requires a transaction to be considered a trading account position if it is entered into as part of dealing activity by an entity engaged in dealing outside the United States. We believe that the status test is overbroad and does not accord with the statutory definition of “trading account,” as positions entered into by registered dealers are included regardless of the banking entity’s purpose regarding the position. For example, covered financial positions entered into by a broker-dealer will be considered trading account positions even if held with long-term intent.<sup>42</sup> To the extent that dealers enter into covered financial positions with short-term intent, those positions will be included in the trading account through the purpose test, making the status test unnecessary.

The Agencies note in the Proposal that the status test reflects the fact that dealers typically enter into positions with short-term intent, implying that these are entered into for undesirable proprietary purposes.<sup>43</sup> We disagree. We see no reason why dealing activity indicates short-term proprietary trading intent. Moreover, we believe that dealing activity is precisely the type of customer-focused activity that is permitted by the statute and that the Agencies should encourage banking entities to engage in. Dealers primarily engage in principal transactions in response to customer demand. Some elements of SEC and CFTC dealing definitions are inapposite to the question of whether proprietary trading occurs. Others indicate that dealing is not for the purpose of proprietary trading but to facilitate markets and customer trades. Finally, dealer registration is required in some jurisdictions for long-term activity, which should not be captured within the trading account.

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<sup>41</sup> We believe this section is responsive to Questions 14 and 22 in the Proposal.

<sup>42</sup> We note that a position held by a broker-dealer or similar entity with long-term investment intent may not be a position “taken in connection with activities . . . that require it to be registered.” Nonetheless, as broker-dealers are not currently required to distinguish between positions taken in connection with activities requiring registration and those that do not, we anticipate considerable difficulty in relying on this position as a practical matter and thus believe the purpose of the statute is better achieved by eliminating the status test. As a result, we worry that status as a registered dealer will result in an overapplication of the Volcker Rule to all positions held by the dealer unless proven otherwise.

<sup>43</sup> Proposal at 68,860 (FRB 33).

We believe that, at most, the status test should be incorporated into the Proposal as a nonexclusive indicative factor of proprietary trading intent, rather than determining that dealing activity is in a trading account.

In addition, since the Proposal looks to whether a banking entity is registered as a swap dealer or security-based swap dealer, it implicitly incorporates the further definition of these terms that Title VII requires the CFTC and SEC to jointly adopt and the registration requirements that Title VII requires each Commission to adopt for those entities under its jurisdiction. The CFTC and SEC have proposed these rules but have not finalized them.<sup>44</sup> As stated above, we believe it is inappropriate under the Administrative Procedure Act to incorporate proposed rules into the current Proposal until they are finalized.<sup>45</sup>

Finally, non-U.S. banking entities, including those that are part of a U.S.-headquartered bank holding company, may be provided “universal banking” licenses in foreign jurisdictions that allow them to engage in a number of different types of activity. The status test could lead to significant uncertainty as to which activities of such a banking entity give rise to such a registration requirement and, as a result, are in the banking entity’s trading account for Volcker Rule purposes.

## F. Sixty-Day Holding Period Presumption

**Recommendation:** The Agencies should refashion the sixty-day holding period presumption and include it as guidance rather than as a hard-coded rule.<sup>46</sup>

The purpose test includes a presumption that any covered financial position held for 60 days or less is a trading account position.<sup>47</sup> We believe that treating any holding period presumption as guidance rather than as a hard-coded rule is a more appropriate way to reflect the differing factors that may affect a holding period. A banking entity’s holding period for a covered financial position is often not dictated by its own intent, but rather is a function of customer demand and the characteristics of the asset at issue. We believe that the 60-day presumption is an example of the Proposal’s negative presumptions that will unduly constrain market making. Rather, we would suggest that this concept be moved to guidance and formulated as a more balanced presumption: the Agencies should state directly that

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<sup>44</sup> See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 Fed. Reg. 80,174, 80,177 (proposed Dec. 21, 2010).

<sup>45</sup> See the discussion beginning on page A-14.

<sup>46</sup> We believe this section is responsive to Questions 17, 23, 26 and 27 in the Proposal.

<sup>47</sup> Proposal § \_\_.3(b)(2)(ii).

covered financial positions that are held for more than 60 days are presumed not to be held with short-term trading intent.

## G. Variation Margin

**Recommendation:** Daily variation margin should not be viewed as an indicator of short-term proprietary trading intent.<sup>48</sup>

The Agencies state that the definition of trading account includes any “derivative, commodity future, or other position that, regardless of the term of that position, is subject to the exchange of short-term variation margin through which the banking entity intends to benefit from short-term price movements.”<sup>49</sup> We believe that the exchange of variation margin should not be viewed as an indicator of short-term proprietary trading intent. Variation margin is a movement of collateral to secure counterparties against the interday movements in the price of a financial instrument. Entities use variation margin to protect themselves from counterparty credit risk, not to realize short-term profits from trading positions. Banking regulators have long recognized this risk-mitigating purpose of margin, as evidenced by the fact that Basel capital rules require the collection of margin or require higher capital charges.

In addition, under Title VII of Dodd-Frank and the Agencies’ rules thereunder, banking entities that are swap dealers, security-based swap dealers, major swap participants or major security-based swap participants will be required to collect variation margin from many counterparties on a daily basis for their swap or security-based swap activity.<sup>50</sup> In addition, entities that clear customer transactions will need to collect daily variation margin from their clearing customers to pass on to clearinghouses. Collection of daily variation margin will not be optional for these entities and, as a result, will not indicate anything about the entity’s purpose in exchanging variation margin or entering into the swap or security-based swap.

As such, we are uncertain what this factor is meant to capture. We do not know how and when, if ever, short-term variation margin could be used with the intent to benefit from short-term price variations. Variation margin is used in a number of contexts that the Agencies have determined do not give rise to Volcker Rule concerns, including repurchase agreements and securities lending agreements. We worry that the Proposal’s

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<sup>48</sup> We believe this section is responsive to Question 19 in the Proposal.

<sup>49</sup> Proposal at 68,858 (FRB 28).

<sup>50</sup> See 7 U.S.C. § 6s(e) (as added by Dodd-Frank § 731); 15 U.S.C. § 78o-10(e) (as added by Dodd-Frank § 764); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (proposed Apr. 28, 2011).

vague statement could seriously discourage the use of variation margin where not regulatorily required. We believe that the Agencies should encourage, rather than discourage, banking entities to engage in sound risk management through variation margin collection.

## II. Market Making-Related Permitted Activity

### A. Effects of Narrow Market Making-Related Permitted Activity

**Observation:** The Agencies' approach to the market making-related permitted activity would have significant deleterious real-world effects on the financial markets and on the investors and customers that rely on such markets for liquidity.<sup>51</sup>

The stakes in correctly implementing the Volcker Rule's market making-related permitted activity are enormous. An overly restrictive permitted activity will decrease liquidity, increase price volatility and make it more difficult for issuers to raise funds in the primary markets.<sup>52</sup> A trial-and-error approach to the permitted activity will not work; once these effects begin, many will be irreversible. As a result, we suggest below<sup>53</sup> a phased-in approach through which the Volcker Rule regulations would first be phased in for banking entities' operations in the United States, followed by banking entities' operations offshore. Each of these categories of market participant would have the rule phased in by asset class.

It is not clear to us that any of the remaining market participants would be well positioned to fill the void left if banking entities are effectively excluded from intermediating the financial markets.<sup>54</sup> In addition, a narrow market making-related permitted activity will impair capital formation. U.S. corporations raise funds by issuing equity and debt securities through the U.S. capital markets. The market price of these securities decreases if the secondary market for them is less liquid, because investors will pay less for the securities if they do not believe they will have the ability to sell easily in the secondary market, usually to banking entities that make markets in the securities. If banking entities are significantly restricted in their secondary market making activities, it will be harder for investors to sell purchased securities at a reasonable price, and demand for initial issuances will suffer. In addition, active market making provides banking entities that serve as underwriters with the knowledge and experience needed to price offerings appropriately. An overly narrow market making-related permitted activity could, therefore, lead underwriters to be overly cautious with respect to pricing. These two factors could combine to significantly impair capital

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<sup>51</sup> We believe this section is responsive to Questions 80, 83, 84 and 357 in the Proposal.

<sup>52</sup> Oliver Wyman 2012 Study at 23 ("As liquidity declines for all securities" because of the Proposal, "the average interest rate of new offerings will increase to compensate investors.").

<sup>53</sup> See the discussion beginning on page A-121.

<sup>54</sup> See the discussion in footnote 17 and accompanying text.

formation,<sup>55</sup> making it difficult for the U.S. corporations that rely on funds raised in the U.S. primary market to fund new projects and sustain U.S. employment.

Nor would the impact on financial markets be limited to the United States. As EU Internal Markets Commissioner Michel Barnier recently observed, “[g]iven the absence of a clear delimitation between what constitutes banned proprietary trading and allowed market making, there is a real risk that banks impacted by the rule would also significantly reduce their market making activities, reducing liquidity in many markets both within and outside the United States.”<sup>56</sup>

## **B. Customer-Focused Market Making-Related Activities**

***Recommendation:*** The Agencies’ approach to market making should be replaced by one in which trading units are allowed to engage in customer-focused market making-related activities.<sup>57</sup>

We believe that the market making-related permitted activity should be structured as a general grant of authority to engage in customer-focused market making-related activity. “Market making” should be defined as the business of being willing to facilitate customer purchases and sales of covered financial positions as an intermediary over time and in size, including by holding positions in inventory. We believe a business should be viewed as customer-focused, and therefore engaged in market making, to the extent it is oriented to meeting customer demand throughout market cycles. This can be evidenced by, among other activity, a focus on offering execution to customers, building relationships with customers and providing sales coverage, providing research to customers and participating in

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<sup>55</sup> Oliver Wyman 2012 Study at 23 (estimating that liquidity impacts of the size projected for the Proposal could result in annual incremental costs to U.S. corporate issuers of \$12 to \$43 billion).

<sup>56</sup> Letter from Michel Barnier, European Commissioner for Internal Market and Services, to the Agencies (Feb. 8, 2012). *See also* Letter from Office of the Superintendent of Financial Institutions Canada to the Agencies (Dec. 28, 2011) (“This is an especially acute concern for Canadian banks and the Canadian financial system more broadly given the deep inter-linkages that have existed for many decades between the Canadian and US financial systems. Canadian financial institutions use US-owned infrastructure to conduct financial transactions in support of their market-making activities in Canada . . .”); Letter from UK Chancellor of the Exchequer George Osborne to Federal Reserve Chairman Ben Bernanke (Jan. 23, 2012) (The Proposal “could result in a reduction in market liquidity, leading to investors experiencing higher costs, delays, and potentially greater price volatility. Over the medium term, this may encourage a migration of market making to outside the regulated banking sector.”).

<sup>57</sup> We believe this section is responsive to Questions 80, 81 and 87 in the Proposal.

the interdealer market in order to serve customer demand.<sup>58</sup> “Market making-related activity” should be defined as any transactions entered into as part of a market making business.

### C. Hard-Coded Factors

**Recommendation:** The hard-coded factors in the Proposal’s rule should be removed from the rule itself and become principles-based guidance for reasonably designed policies and procedures. The Agencies should receive information from quantitative metrics, policies and procedures and examinations to oversee the system.<sup>59</sup>

For the reasons discussed below, we believe the hard-coded criteria currently in the rule are inappropriate and do not capture the wide range of market making-related activities in various financial markets. As a result, we believe the relevant hard-coded criteria in the Proposal should be recast as guidance—within the adopting release but not the rule—as to what constitutes such market making-related activity. Banking entities should be required to adopt written policies and procedures incorporating this guidance, which should include specific risk limits for each trading unit. The Agencies can ensure that market making is not being used as a disguise for speculative proprietary trading through examinations and the use of relevant quantitative metrics.<sup>60</sup>

While Appendix B includes some of the Agencies’ guidance as to what constitutes market making, we believe that it has two problems as currently constructed. First, the Proposal requires that banking entities comply with all explicit provisions in the rule *in addition to* Appendix B.<sup>61</sup> Second, rather than focusing on permitted market making-related activities, as indicated by its title “Commentary Regarding Identification of Permitted Market Making-Related Activities,” Appendix B appears to be written from the negative viewpoint, describing speculative proprietary trading activity rather than what market making is. As stated above,<sup>62</sup> we believe that such negative presumptions are inappropriate. We believe that an Appendix that elucidates what market making is, rather than what it is not, would be more

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<sup>58</sup> As discussed beginning on page A-44, we strongly believe that interdealer trading activities are critical to market making.

<sup>59</sup> We believe this section is responsive to Questions 80, 81 and 87 in the Proposal.

<sup>60</sup> Below we discuss how we think these metrics need to be revised. *See* the discussion beginning on page A-103.

<sup>61</sup> *See* Proposal § \_\_.4(b)(2).

<sup>62</sup> *See* the discussion beginning on page A-13.



useful and consistent with congressional intent. Acting as a market maker in accordance with the guidance would be presumptively permissible as indicated in the statute.

The approach outlined above would be carefully supervised by the Agencies. Banking entities would be required to adopt written policies and procedures with risk limits and controls, monitored by the Agencies through examinations. More importantly, however, banking entities that have substantial trading volumes would be required to report a set of quantitative metrics, subject to the suggested revisions for Appendix A discussed below.<sup>63</sup> Some metrics may be more relevant than others, depending upon the particular asset class, activity, particular market and unique characteristics of each banking entity, and some metrics may just be informative rather than signaling a need for further discussion. Over time, based on discussions with examiners, the business and examiners would determine the usefulness and relevance of such metrics, and would learn how metrics may be better used to keep a focus on customer activity. Once appropriate parameters (including relevant metrics) to ensure customer orientation have been established for a business, the business should be presumed to be a market-making business if it consistently operates within those parameters.

This approach to the metrics is consistent with the Proposal and with the FSOC's view of metrics as an "objective set of data that (i) brings to supervisory attention trading trends or incidents that may suggest that violations have occurred and (ii) facilitates the comparison of such trading data across banking entities, market segments, or trading strategies to inform and strengthen the supervisory process" and as a "key source of information for identifying potentially problematic trading activities that may require further study, rather than a comprehensive, dispositive tool."<sup>64</sup> In addition, by viewing compliance through metrics that aggregate activities of a trading unit rather than viewing compliance transaction by transaction, the Agencies would base their oversight on the holistic market making activity rather than at a transaction-by-transaction level.<sup>65</sup>

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<sup>63</sup> See the discussion beginning on page A-103. Similar to the requirements in the Proposal, we believe that a *de minimis* threshold should exist under which fewer metrics must be calculated.

<sup>64</sup> FSOC Study at 36-37.

<sup>65</sup> See the discussion beginning on page A-34.

## D. Differences in Market Making Between Markets

**Observation:** In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in *any* market, even the most liquid equity markets.<sup>66</sup>

In many places, the Proposal seems to be premised on the idea that one or a few general models are sufficient to capture the full range of transactions in the financial markets. We believe this is most problematic in the market making-related permitted activity, which seems to view market making based on a liquid, exchange-traded equity model in which market makers are simple intermediaries akin to agents. This view does not fit market making even in equity markets and widely misses the mark for the vast majority of markets and asset classes. As such, it is not a reasonable interpretation of the statutory text, which protects market making-related activities in all covered financial products.<sup>67</sup>

As discussed below,<sup>68</sup> the Proposal states initially that its “core element” requires that a market maker “hold itself out as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular or continuous basis.”<sup>69</sup> In largely importing the Securities Exchange Act and Regulation SHO definitions of a “market maker,”<sup>70</sup> the Proposal seems heavily dependent on the model of a market maker in liquid equities, whose characteristics are the exception rather than the norm for most covered financial instruments.<sup>71</sup> Despite subsequent references to less stringent market maker standards for less liquid instruments,<sup>72</sup> this archetype of liquid

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<sup>66</sup> We believe this section is responsive to Questions 80, 81, 87, 88, 89, 90, 92, 93 and 177 in the Proposal.

<sup>67</sup> See *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

<sup>68</sup> See the discussion beginning on page A-37.

<sup>69</sup> Proposal at 68,870 (FRB 56).

<sup>70</sup> 15 U.S.C. § 78c(a)(38). In particular, the Agencies cite the exception for market makers from the “locate” requirement under Regulation SHO and the related discussion of what constitutes a market maker, which is highly equity-oriented and is narrower than even the Agencies’ market making-related permitted activity. See Amendments to Regulation SHO, 73 Fed. Reg. 61,690, 61,698-99 (Oct. 17, 2008).

<sup>71</sup> As a result, SIFMA does not agree with the Agencies’ assertion that using the Section 3(a)(38) definition of “market maker” from the Exchange Act is “consistent with the scope of *bona fide* market making-related activities in which banking entities typically engage.” Proposal at 68,870 (FRB 56).

<sup>72</sup> The Agencies note that the “precise nature of a market maker’s activities often varies depending on the liquidity . . . of the market . . . . In less liquid markets, such as over-the-counter markets for debt and equity securities or derivatives, the appropriate indicia of market making-related activity will vary, but should generally include: holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis; with respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market; and transaction (...continued)

equity market making pervades the market making-related provisions of the Proposal. For example, trading units engaged in market making-related activity are required to design their activities to primarily generate revenues through bid-ask spreads and customer fees and commissions.<sup>73</sup> As discussed below,<sup>74</sup> this does not reflect the liquid equities market when trades are made in size or market making in less liquid markets regardless of size. Also, a market maker even in the liquid equities market does not act only as broker or agent and must retain inventory to satisfy customer demand. If the Proposal does not fully reflect the reality of market making in most instruments, then the Proposal is imposing on all activities a model that attempts to define market making too narrowly and, consequently, the liquidity for many asset classes currently provided by banking entities will be severely curtailed.

The U.S. corporate bond market serves as a useful example of an important market that does not follow the Proposal's implicit market making paradigm and, as such, is jeopardized by the proposed permitted activity. The structure of this market differs significantly from that of the liquid equities market, and, hence, market makers function in different ways. The corporate bond market is significantly more fragmented than the listed equities market, with many individual bonds with little or no trading activity. At the end of 2009, there were roughly 37,000 corporate bonds outstanding with a market value of \$7 trillion, while there were only 5,000 publicly traded equities with a market value of \$15 trillion, evidencing this fragmentation.<sup>75</sup> Any given public corporation is likely to have many issued corporate bonds that may differ in yield, maturity and delivery date, among a host of other factors. As a result, individual corporate bonds are generally far less liquid than individual listed equities. In serving as a market maker for a customer in the U.S. corporate bond market, therefore, a banking entity buys a bond from or sells a bond to a customer with the knowledge that there may be little chance of rapidly reselling the bond and a high likelihood they will have to hold on to that bond for a significant period of time.<sup>76</sup> The market maker thus becomes exposed, as principal, to the risk of the market value of the bond

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(continued...)

volumes and risk proportionate to historical customer liquidity and investments needs." Proposal at 68,870-71 (FRB 56-57).

<sup>73</sup> See Proposal § \_\_.4(b)(2)(v) (stating that market making-related activities must be "designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income not attributable to: [a]ppreciation in the value of covered financial positions").

<sup>74</sup> See the discussion beginning on page A-30.

<sup>75</sup> Oliver Wyman, *The Volcker Rule: Considerations for Implementation of Proprietary Trading Regulations* (Dec. 22, 2010), at 23. Many of these equity securities also lack active markets and need positioning as part of market making activity.

<sup>76</sup> While Appendix B does recognize that "[t]he size and type of risk that must be retained in such cases may vary widely depending on the type and size of the positions, the liquidity of the specific market, and the market's structure [and that as] the liquidity of positions increases, the frequency with which a market maker must take or retain risk in order to make a market in those positions generally decreases," this concept does not seem to be carried through the rest of the analysis of market making. Proposal, Appendix B § III.A.

in a way that a market maker in liquid equity securities, who may be able to buy and sell nearly contemporaneously and generate revenue from the spread, is not. In many instances, the changes in the market value of the bond may be the primary driver of the banking entity's revenues.

This model of taking principal positions as part of market making operates in most markets. Market makers exist because many markets have low liquidity, few participants and no centralized exchanges. The markets for commodities, derivatives, securitized products and emerging market securities, among many others, are characterized by even less liquidity and less frequent trading than the U.S. corporate bond market. While Appendix B helpfully notes that "in the case of a derivative contract, these revenues reflect the difference between the cost of entering into the derivative contract and the cost of hedging incremental, residual risks arising from the contract,"<sup>77</sup> such treatment is not expressly extended to less liquid non-derivative instruments.

Because the equity archetype of market making is not applicable to the vast majority of markets, nor to much of the equities markets themselves in all circumstances, banking entities would face major impediments to effectively intermediating as principal in these markets. As a result, customers would need to look to other financial institutions to serve as market makers or would be left without the ability to trade in these instruments. This would have significant disruptive effects for secondary market trading and, in turn, capital formation. In addition, since acting as a market maker in these markets requires significant inventory, only financial entities with sizable balance sheets could fill this role. It is unlikely that other market participants would be willing and able to fill this role in the short term.

Agency-like markets cannot replace the principal trading that banking entities currently conduct to meet the near-term demand of customers in less liquid instruments. Liquid agency markets require frequent turnover in the instruments or numerous active liquidity providers that cumulatively provide immediate liquidity. These conditions do not exist in the fixed income or derivatives markets, nor are they likely to develop in the near future. If these markets could support agency trading, they likely would have already taken on this structure.

As a result, we believe that the Agencies should formulate the market making-related permitted activity to enable banking entities to continue to serve customers through principal positions. This requires accounting for the differences in the markets where banking entities act as market makers. While the Proposal does distinguish between more and less liquid markets,<sup>78</sup> and allows some market making in derivatives through hedging derivatives

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<sup>77</sup> Proposal, Appendix B § III.A.

<sup>78</sup> For example, as discussed beginning on page A-37, the Preamble states that "in the context of relatively liquid positions, such as equity securities or other exchange-traded instruments, a trading desk or other organizational unit's market making-related activity should generally include: making continuous, two sided (...continued)

risk, it should make entirely clear how disparate the forms of market making may be and that many forms of transactions related to market making are necessary to be an effective market maker. The Proposal’s minor glosses to the model, which itself does not even fit the equity markets, are not sufficient.

## E. Market Making vs. Market Making-Related Activity

**Observation:** The hard-coded set of criteria appears to reduce the permitted activity to “market making,” rather than “market making-related,” activity, contrary to congressional intent.<sup>79</sup>

The statutory Volcker Rule permits “the purchase, sale, acquisition or disposition of securities and other instruments . . . in connection with . . . market-making-related activities.”<sup>80</sup> As such, the statute explicitly, and by its plain language, unambiguously, includes activities that are not themselves market making.<sup>81</sup> The fact that the word “related” was added to the text of Dodd-Frank during the House-Senate conference on the bill, which previously only allowed for “market making,” further evidences clear congressional intent to include that word and have the permitted activity incorporate more than pure market making.<sup>82</sup>

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(continued...)

quotes and holding oneself out as willing to buy and sell on a continuous basis; a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity; making continuous quotations that are at or near the market on both sides; and providing widely accessible and broadly disseminated quotes” while, “in less liquid markets, such as over-the-counter markets for debt and equity securities or derivatives, the appropriate indicia of market making-related activities will vary, but should generally include: holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis; with respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market; and transaction volumes and risk proportionate to historical customer liquidity and investments needs.” Proposal at 68,870-71 (FRB 56-57).

<sup>79</sup> We believe this section is responsive to Questions 80, 87 and 89 in the Proposal.

<sup>80</sup> Bank Holding Company Act § 13(d)(1)(B) (as added by Dodd-Frank § 619) (emphasis added).

<sup>81</sup> It is a rule of statutory construction that every word in a statute must be given effect and the absence of the “related” concept is a surprising omission of statutory text that is unambiguous. See *Chevron U.S.A. Inc., v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

<sup>82</sup> See Statement of Senator Merkley, 156 Cong. Rec. S5896 (July 15, 2010) (The intent of Congress was to “permit certain legitimate client oriented services, such pre-market-making accumulation of small positions that might not rise to the level of fully ‘market-making’ in a security or financial instrument, but are intended to nonetheless meet expected near-term client liquidity needs. Accordingly, while previous versions of the legislation referenced ‘market-making,’ the final version references ‘market-making related’ to provide the regulators with limited additional flexibility to incorporate those types of transactions to meet client needs, without unduly warping the common understanding of market making.”).

The Proposal, however, appears to view the market making-related permitted activity as limited to market making transactions.<sup>83</sup> For example, as discussed in greater detail below,<sup>84</sup> the Proposal requires that a particular transaction be entered into based on the “reasonably expected near term demands of clients, customers or counterparties.”<sup>85</sup> As such, this factor could be viewed as not including transactions entered into to build inventory, which are a necessary part of an overall market making activity that responds to the “reasonably expected near term demands of clients, customers, or counterparties.” As discussed below,<sup>86</sup> for example, market makers in exchange-traded funds (“ETFs”) enter into a number of transactions, such as creating and redeeming ETF shares, that are critical parts of their ETF market making function. Similarly, “market making-related” transactions should include transactions entered into for price-discovery purposes; for example, if Security A and Security B have some price correlation but neither trades regularly, a trader may execute a trade for price discovery purposes, using the price of Security A to make an informed bid-ask market to a customer for Security B.

## F. Sources of Revenue

**Recommendation:** The Agencies should not require, even in guidance, that market making-related permitted activities be “designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income.” This formulation exceeds statutory intent, prejudices appropriate results for revenue metrics and ignores the fact that, frequently, a *bona fide* market maker may not be able to provide market making services unless it can benefit from revenues from market movements.<sup>87</sup>

The market making-related permitted activity of the Proposal requires that activities be “designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income not attributable to . . . appreciation in the value of covered financial positions it holds in trading accounts [or] the hedging of covered financial positions it holds in

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<sup>83</sup> As discussed above, we think that the formulation of the permitted activity in the Proposal is not even broad enough to allow for all pure market making activities. See the discussion beginning on page A-26.

<sup>84</sup> See the discussion beginning on page A-41.

<sup>85</sup> We understand that this requirement comes from the statutory Volcker Rule statement that market making-related activities should be “designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.” Bank Holding Company Act § 13(d)(1)(B) (as added by Dodd-Frank § 619). However, as noted below, this statutory requirement is based on the activity overall, not each individual transaction. See the discussion beginning on page A-41.

<sup>86</sup> See the discussion beginning on page A-51.

<sup>87</sup> We believe this section is responsive to Questions 80, 81, 87, 96, 177 and 184 in the Proposal.

trading accounts.”<sup>88</sup> As stated above,<sup>89</sup> we generally believe that the hard-coded requirements in the market making-related permitted activity should be removed from the rule and recast as guidance. However, we believe this requirement is so problematic as to justify deleting it completely and not including it as guidance.

In the statutory Volcker Rule, Congress explicitly permitted banking entities to engage in market making-related activity that otherwise would be prohibited proprietary trading. The statutory provision does not limit market making to specific asset classes,<sup>90</sup> nor does it proscribe or limit revenues from market movements by market makers in any way. As discussed below, a significant amount—in some cases the majority—of a market maker’s revenue, particularly in less liquid markets, may come from the “appreciation in the value of covered financial positions [the market maker] holds in trading accounts.” As a result, requiring that a market maker’s activities be designed primarily to generate revenue from other sources contravenes congressional intent to allow market making to continue.

As part of their critical time intermediation function,<sup>91</sup> market makers hold positions for periods of time during which those positions are exposed to up and down movements in the price of the covered financial instrument. Market makers must actively avoid losing money from price depreciation. Since inventory is crucial to market making activity in less liquid markets, and this inventory may be held for significant periods of time, movements in this inventory must be permitted to generate revenue and profit.

Revenue sources will differ significantly by asset class. In markets where trades are large and less frequent, such as the market for customized securitized products, appreciation of the price of a covered financial position may be a major (or the predominant) contributor to revenues, since one position moving up or down significantly may have a marked impact on the profit and loss of the trading unit. While Appendix B has commentary stating that the appropriate composition of revenues will differ based on asset class,<sup>92</sup> that concept is not incorporated into the rule text, and other Proposal statements are not consistent with the point.<sup>93</sup> The fact that the Agencies require that the activity must not be “designed to

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<sup>88</sup> Proposal § \_\_.4(b)(2)(v).

<sup>89</sup> See the discussion beginning on page A-23.

<sup>90</sup> Relatedly, as stated in our letter on the covered fund provisions of the Proposal, we believe that the covered fund provisions of the Volcker Rule are not intended to restrict banking entities from engaging in market making-related, risk-mitigating hedging, underwriting and other permitted activities with respect to securities issued by covered funds.

<sup>91</sup> See the discussion beginning on page A-36.

<sup>92</sup> The Agencies note that the “appropriate proportion of ‘customer revenues’ to profits and losses resulting from price movements of retained principal positions and risks varies depending on the type of positions involved, the typical fees, commissions, and spreads payable for transactions in those positions, and the risks of those positions.” Proposal, Appendix B § III.A.

<sup>93</sup> See the discussion beginning on page A-26.

generate revenues *primarily* from fees, commissions, bid-ask spreads[, etc.]” places a limit on the extent to which the sources of income can differ by asset class.

Second, in many markets, revenues from “hedging of covered financial positions [the market maker] holds in trading accounts” are equivalent to spreads, as a trading unit acts as a market maker by taking on a position and hedging the risk of that position, generating revenues from the difference between the customer price for the position and the banking entity’s price for the hedge.<sup>94</sup> The Agencies understand this with respect to derivatives, noting in Appendix B that “[i]n the case of a derivative contract, [customer-related] revenues reflect the difference between the cost of entering into the derivative contract and the cost of hedging incremental, residual risks arising from the contract.”<sup>95</sup> This form of market making through hedging, however, arises in markets for other covered financial positions, such as less liquid bonds, and should be allowed in those markets as well.<sup>96</sup> In addition, this concept of appropriate revenue generation through hedging should be incorporated wherever the general revenue restriction appears so that banking entities are not in the position of deciding whether the text currently in the rule or the indicative language in Appendix B governs.

The Agencies have failed to take account of these various market realities. The Supreme Court has explained that it is impermissible under the Administrative Procedure Act for an agency to “offer[] an explanation for its decision that runs counter to the evidence before the agency.”<sup>97</sup> Accordingly, the Agencies should clarify in the final regulations that *bona fide* market making-related activities are permissible even if they generate revenues from price appreciation.

In addition to these problems, we do not believe the Proposal’s implicit assumption that every dollar can be attributed to either direct customer revenues or appreciation/hedging profits is true. In some sense, the difference between the bid-ask spread and price appreciation is metaphysical. Suppose a market maker provides a bid in response to a customer’s desire to sell an instrument that is substantially below the price at which the market maker hopes to resell the instrument. If the customer accepts that bid and the market maker is able to sell at the higher price, it is academic to ask whether the revenue resulted

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<sup>94</sup> As discussed further below, we believe that the Agencies should explicitly state that banking entities can hedge risks using the most economical position without fear of being considered to be engaged in speculative activity as long as that position otherwise satisfies the risk-mitigating hedging requirements. See the discussion beginning on page A-70.

<sup>95</sup> Proposal, Appendix B § III.A.

<sup>96</sup> In these markets, market makers may take a position in the bond in response to customer demand and then hedge the market, credit and other risks through instruments including equity securities, forwards, futures and swaps.

<sup>97</sup> *Motor Vehicle Mfrs. Ass’n of United States, v. State Farm Mutual Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).



from bid-ask spreads on one hand, or whether the bid should be viewed as the current market price and the revenue viewed as resulting from price appreciation on the other. Similarly, looking to a bid-ask spread is inapposite in the context of block trading, where the customer is willing to pay a premium for the ability to trade in size and transaction prices are off-market. Nonetheless, the Proposal seems to suggest that every dollar can be attributed to either direct customer revenues or appreciation/hedging profits.

As part of their critical size intermediation function,<sup>98</sup> market makers are often left with large sizes of covered financial positions that they need to sell into the market. These covered financial positions may or may not technically constitute a block.<sup>99</sup> If the market maker attempts to sell those positions in the open market all at once, the increased supply will significantly depress the price the market maker can get for the position. As a result, to ensure the stability of the market and to make market making a non-revenue-losing function, market makers must be able to sell the covered financial positions over time. In doing so, however, the market maker is technically holding on to a covered financial position for a prolonged time as a function of expected revenues from price movements. This concern is somewhat ameliorated in the case where the position technically constitutes a block and the market maker can avail itself of the block positioner provision, although, as discussed below,<sup>100</sup> significant problems with that provision exist.

A number of the specific factors in Appendix B present the same problems as the rule text regarding market maker revenues. For example, the “revenues relative to risk” factor states that market makers generally (i) do not generate only very small or very large amounts of revenue per unit of risk taken; (ii) demonstrate consistent profitability; and (iii) do not demonstrate high earnings volatility.<sup>101</sup> While the Agencies do state that unexpected market disruptions may be an explanatory factor as to why market makers would not function in this manner, the Agencies do not appear to fully appreciate that some markets are extremely volatile and, as a result, market makers in these markets often see large upward or downward swings over time.<sup>102</sup> It is unclear whether these are “unexpected market disruptions.” In addition, the idea that revenues from pure price appreciation only result from “unexpected market disruptions” assumes that the baseline set by the Agencies for what constitutes market making is appropriate. As we discuss above,<sup>103</sup> we believe that the

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<sup>98</sup> See the discussion beginning on page A-36.

<sup>99</sup> Regardless, as we note above, there are significant problems with the Proposal’s limited allowance for block positioning. See the discussion beginning on page A-40.

<sup>100</sup> See the discussion beginning on page A-40.

<sup>101</sup> Proposal, Appendix B § III.C.3.

<sup>102</sup> See Proposal, Appendix B § III.C.3; *id.* at § III.A.

<sup>103</sup> See the discussion beginning on page A-22.

Proposal’s market making framework is overly narrow and, as a result, does not set an appropriate baseline.

Finally, while the Agencies have not explicitly set ranges of appropriate quantitative metrics, requiring that revenues be *primarily* from fees and other direct customer revenue, rather than market movements, sets natural limits on the values of metrics. As stated below,<sup>104</sup> we do not believe that the Agencies should set ranges for what constitutes “appropriate” metrics results and should, instead, consider the metrics to be a signal as to when further discussion of a banking entity’s activities might be appropriate. As a result, we do not think that a provision that sets a ceiling for the sources of revenue metrics is appropriate, even as guidance.

For all of these reasons, we believe that banking entities should not be required to design their market making activities to obtain revenue primarily from fees and other direct customer revenue. We accept that revenue patterns can be instructive at times regarding the nature of a market maker’s business, but we do not believe that revenue constraints should be part of the rule. If the Agencies believe it is necessary to address this factor explicitly in the final rule, we believe it should be at most guidance into which the Agencies incorporate our comments above.

## G. Transaction-by-Transaction Approach

**Recommendation:** The Agencies should not analyze the market making-related permitted activity on a transaction-by-transaction basis.<sup>105</sup>

The statutory Volcker Rule allows the “purchase, sale, acquisition, or disposition of securities and other instruments . . . in connection with . . . market making-related *activities*.”<sup>106</sup> In doing so, the statute evidences an activity-by-activity inquiry, rather than a transaction-by-transaction test.<sup>107</sup> The Proposal, however, appears to evaluate permitted activities through transaction-by-transaction tests. The rule implementing the

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<sup>104</sup> See the discussion beginning on page A-106.

<sup>105</sup> We believe this section is responsive to Questions 80 and 81 in the Proposal.

<sup>106</sup> Bank Holding Company Act § 13(d)(1)(B) (as added by Dodd-Frank § 619) (emphasis added).

<sup>107</sup> We believe the Agencies adopted this approach in an attempt to ensure that no single proprietary transaction escapes their notice. The Agencies, however, should avoid this all-too-familiar error of trying to eliminate “the last 10 percent” of the problem Congress was attempting to address. See Stephen Breyer, *BREAKING THE VICIOUS CIRCLE: TOWARD EFFECTIVE RISK REGULATION* 11 (1993). Congress’ aim is accomplished if the activities constituting the lion’s share of the perceived risk are regulated; every aspect of such behavior need not be regulated, particularly if doing so poses disproportionate negative consequences.

permitted activity states that “[t]he prohibition on proprietary trading . . . does not apply to the purchase or sale of a *covered financial position* by a covered banking entity that is made in connection with the covered banking entity’s market making-related activities.”<sup>108</sup> This transaction-by-transaction approach is echoed in the rule language of each of the requirements, which are predicated by the statement that “a purchase or sale of a *covered financial position* shall be deemed to be made in connection with a covered banking entity’s market making-related activities only if” each of the requirements is met.<sup>109</sup> It further surfaces in rule requirements themselves, as well as the discussion of those requirements in Appendix B and the Preamble.

We believe that the Agencies should give full effect to the statutory intent to allow market making by viewing the permitted activity on a holistic basis. The difference is more than academic. An individual position may not fit squarely into the tight box of a permitted activity as drawn by the Proposal, but may be part of a pattern of market making-related activity that does. In addition, applying a full Volcker Rule analysis to each individual position will be so burdensome as to effectively prohibit many trading units from using the market making-related permitted activity at all. A trading unit may enter into thousands of transactions on a given day as part of its market making business. Such a trading unit simply will not have the ability or resources to justify each individual trade in isolation.

Similarly, when applied at an overall business activity level, we agree with the Agencies’ conceptual statement that market makers generally make, rather than take, liquidity.<sup>110</sup> However, we do not believe this is necessarily true for any particular transaction. As part of *bona fide* market making-related activity, market makers must often take liquidity from another market maker in a particular transaction, for example to understand market pricing, to ensure that prices remain in line<sup>111</sup> or to build inventory.<sup>112</sup>

Viewing individual transactions or positions as “market making” positions or “non-market making” positions also assumes that a banking entity enters into a transaction for one purpose and that market making activities are severable and separately identifiable. With the advent of portfolio trading based on computational and mathematical models, this is certainly no longer true, if it ever was. A position entered into as part of market making-related activities may serve multiple functions—it may be responsive to customer demand, it may hedge a risk and it may build a market maker’s inventory, all at the same time.

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<sup>108</sup> Proposal § \_\_.4(b)(1) (emphasis added).

<sup>109</sup> Proposal § \_\_.4(b)(2) (emphasis added).

<sup>110</sup> See Proposal, Appendix B § III.A.

<sup>111</sup> This concept is dealt with in more detail below. See the discussion beginning on page A-49.

<sup>112</sup> See the discussion beginning on page A-41.

In the Proposal, the Agencies have appropriately recognized “patterns” as being relevant to the identification of market making activity. For example, in discussing the sources of revenue provision, the Agencies note the criterion is meant to ensure market making activities demonstrate certain “*patterns* of revenue generation and profitability.”<sup>113</sup> We believe the Agencies were correct to emphasize such patterns of activity, rather than individual transactions, as indicative of market making.

As a result, we believe that the Agencies should approach the market making-related permitted activity on a holistic basis, rather than transaction by transaction or position by position. This should be clearly reflected here and elsewhere in the Proposal to clearly focus on the complete activity rather than individual transactions.

## H. The Role of Market Makers as Intermediaries

***Recommendation:*** The regulations implementing the market making-related permitted activity should reflect the role of market makers as intermediaries between market participants in different physical locations, at different times and in different sizes.<sup>114</sup>

At the highest level of generality, market makers intermediate risk in three ways. First, market makers serve as a meeting point for buyers and sellers. In an extremely simple example, a buyer’s and a seller’s needs could arise contemporaneously or nearly contemporaneously, but may not be in the same physical location or otherwise have direct access to each other. Market makers may satisfy the needs of both the buyer and seller and charge a fee for this service in the form of a bid-ask spread or commission. While this is a critical purpose of market making, the Agencies’ approach to the market making-related activity suggests that it is the only role of a market maker. The other two fundamental roles of market makers—intermediating through time and in size—are overlooked.

Most transactions in financial instruments do not fit the simple example above—buyers and sellers in the same instrument do not generally appear to market makers simultaneously. However, sellers do not want to wait until a buyer appears, and buyers do not want to wait until a seller appears. As a result, market makers intermediate over time. In doing so, the market maker becomes exposed to a number of risks, including the risk that the position will move adversely during the holding period and the risk that no counterparty will appear to take the position from the market maker. As a result, the market maker should and does analyze the possible price movements of the position before agreeing to intermediate this

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<sup>113</sup> Proposal at 68,872 (FRB 60) (emphasis added).

<sup>114</sup> We believe this section is responsive to Questions 80, 81 and 90 in the Proposal.

time risk. Over time, as positions move, the concept of a static bid-ask spread disappears. The principal risk borne by the market maker over time can translate into significant profit or loss based on the movements in the price of the position.

Transactions in financial instruments also do not fit the simple example above when a buyer or seller of a financial instrument wants to transact in large size. The buyer, seller and even market maker are very unlikely to be able to find a counterparty willing or able to do a trade of the large desired size. The buyer or seller does not want to break up its large position into smaller positions and trade them in the market over a short period of time, as doing so will exert price pressure against the buyer or seller. Market makers intermediate this “size risk” by taking on the large position from the buyer or seller, managing it over time, and laying off the position bit by bit as to not overwhelm the market supply and demand dynamics. In doing so, the market maker is by definition gearing its activity to the profit or loss it will obtain from movements in the price of the position. The Proposal recognizes this critical “size intermediation” function in only one place, the discussion of the block positioner provision.<sup>115</sup> As discussed below,<sup>116</sup> that provision is unreasonably narrow and does not enable many large transactions, whether they qualify as blocks or not.

## I. Holding Oneself Out as a Market Maker

**Observation:** The Proposal’s discussion of what constitutes a market maker “hold[ing] itself out as being willing to buy and sell . . . on a regular or continuous basis” is too narrow to reflect market making in the vast majority of markets.<sup>117</sup>

The Proposal requires that a trading desk using the market making-related permitted activity must “hold[] itself out as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular or continuous basis.”<sup>118</sup> For liquid markets, this requires that the activity generally include:

- making continuous, two sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
- a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;

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<sup>115</sup> See Proposal at 68,871 (FRB 57).

<sup>116</sup> See the discussion beginning on page A-40.

<sup>117</sup> We believe this section is responsive to Questions 80, 81, 87, 88, 91, 92 and 184 in the Proposal.

<sup>118</sup> Proposal § \_\_.4(b)(2)(ii).

- making continuous quotations that are at or near the market on both sides; and
- providing widely accessible and broadly disseminated quotes.<sup>119</sup>

The Agencies note that this approach is consistent with the SEC’s market maker exclusion from the locate requirement of Regulation SHO.<sup>120</sup> For less liquid markets, the Agencies provide a slightly different set of indicia. In particular, these include:

- holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;
- with respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market; and
- transaction volumes and risk proportionate to historical customer liquidity and investments needs.<sup>121</sup>

These requirements are contrary to the statute. At its core, the Agencies’ regulatory approach presupposes market making as only involving a liquid market in which instruments trade continuously. However, financial products and trading activities vary in their nature, requiring market makers to assume different roles for different instruments. Simply put, in today’s complex instruments, market makers’ activities can be designed singlemindedly to meet near-term customer demand and yet not involve trading continuously in the market, providing liquidity on a regular schedule, or holding oneself out as willing to buy or sell under all circumstances. In light of this, Section \_\_.4(b) is inconsistent with the statutory exemption for market making to the extent it requires that one hold oneself out as being “willing to buy and sell” on a “regular or continuous basis.” The Agencies should not graft on to the statute a liquid market requirement that does not comport with how the market actually functions. The Preamble purports to recognize the prospect of an illiquid market,<sup>122</sup> but it does not fully reflect this possibility or address other concerns raised by its restrictive approach. For example, it would still require that a market maker provide “regular” quotes. Again, this ignores the realities of the markets. Indeed, by definition, one does not provide regular quotes on customized derivatives.

As a general matter, we believe that a trading unit should be viewed as a market maker if it is willing to respond to customer demand by providing prices to clients

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<sup>119</sup> Proposal at 68,870-71 (FRB 56-57).

<sup>120</sup> See Proposal at 68,871 n.148 (FRB 57 n.148) (citing 17 C.F.R. § 242.203(b)(2)(iii)).

<sup>121</sup> Proposal at 68,871 (FRB 57).

<sup>122</sup> See Proposal at 68,870-71 (FRB 57).

upon demand.<sup>123</sup> We believe that the Agencies should expressly recognize that a wide range of markets will govern the nature of market making in these markets.<sup>124</sup> Thus, the conceptual framework of “continuous” or “regular” quotations does not adequately reflect the fact that, with a myriad of existing instruments in any market, it is impossible to continuously or even regularly quote in all instruments in which a trading unit is willing to respond to customer demand. As discussed above,<sup>125</sup> a market maker is an entity that is willing to intermediate in the financial markets, between customers, over time and in different sizes. Historical activity, including quotes, in the particular financial instrument is not a determinative factor.

The Proposal’s conceptual framework of what it means to “hold oneself out” as a market maker in *liquid* instruments is also incomplete. As noted above, the Agencies have drawn the indicia of market making in liquid products from the requirements that a market maker must meet to be exempted from the locate requirements under Regulation SHO. We believe that it is too limiting for the Agencies to fashion a “permitted activity” around a purposely narrow exemption from another regulatory requirement. The context is entirely different. For example, failing to meet the narrow Regulation SHO definition of “market maker” does not mean that the SEC does not consider the entity a market maker—it simply means that the entity is not eligible for the exemption from the locate requirement.

The Proposal’s conceptual framework of what it means to “hold oneself out” as a market maker in *less liquid* instruments is similarly incomplete. In many less liquid financial instruments, “regular” quotation systems do not exist. Similarly, there may be no or very little data on “historical customer liquidity and investments needs” upon which to base an analysis of appropriate transaction volumes and risk.

We also believe that the Agencies should clarify the level of granularity used in determining whether a trading desk holds itself out as willing to trade in a particular position. The Proposal states that “a banking entity relying on the exemption with respect to a particular transaction must actually make a market in the covered financial position involved; simply because a banking entity makes a market in one type of covered financial position does not permit it to rely on the market-making exemption for another type of covered financial position.”<sup>126</sup> It is not clear, however, how narrowly the term “covered financial position” will be treated in this context and, as a result, what range of similar instruments will be considered to be within the scope of market making-related activities. For example, if a trading desk regularly trades in standardized interest rate swaps and is approached by a client

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<sup>123</sup> See the discussion beginning on page A-23, stating that the Agencies should define market making as “the business of being willing to facilitate customer purchases and sales of covered financial positions as an intermediary over time and in size, including by holding positions in inventory.”

<sup>124</sup> See the discussion beginning on page A-26.

<sup>125</sup> See the discussion beginning on page A-36.

<sup>126</sup> Proposal at 68,870 (FRB 56).

regarding a customized interest rate swap, that trading desk should be considered a market maker when it engages in a transaction in that closely related product. To avoid confusion, we recommend that the Agencies clarify that in this context the trading unit could hold itself out as willing to buy and sell a particular type of instrument, rather than a particular instance of a covered financial product. More generally, we believe that customer-focused trading units should be viewed as making markets in a specific instrument regardless of whether they have transacted in that type of instrument before.

## J. Block Positioners

**Recommendation:** The interpretation of “block positioner” should be expanded to address the differences between asset classes.<sup>127</sup>

The Proposal permits block positioning “if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading.”<sup>128</sup> The Agencies do not define “block positioner,” but note that the SEC’s existing definition of “qualified block positioner” in Rule 3b-8(c) “may serve as guidance in determining whether a block positioner engaged in block positioning is engaged in *bona fide* market making-related activities.”<sup>129</sup> The definition of “block positioner” in Rule 3b-8(c) requires, among other things, that the block positioner determine that the block could not be sold to or purchased from others on equivalent or better terms and sell the shares composing the block as rapidly as possible commensurate with the circumstances.<sup>130</sup>

As an initial matter, we would note that Rule 3b-8 was adopted to restrict access to bank credit to a narrow class of equity market makers. This purpose is at odds with the market making-related permitted activity, which is intended to preserve customer access to market maker principal trading.

In addition, because Rule 3b-8 applies to equity blocks, its equity orientation needs to be revised to reflect the conditions in the markets for other instruments. First, it should be noted that most transactions entered into by institutions in less liquid instruments have the price impact characteristics of block trades in equity markets, so the block positioner exemption is of heightened importance in these markets. This is particularly true if the general market maker definition continues to reflect the equity markets archetype. Second, it

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<sup>127</sup> We believe this section is responsive to Questions 82, 85, 86, 90 and 91 in the Proposal.

<sup>128</sup> Proposal at 68,871 (FRB 57).

<sup>129</sup> Proposal at 68,871 n.151 (FRB 57-58 n.151).

<sup>130</sup> See 12 C.F.R. § 240.3b-8(c)(4)(iii).



is unclear how a block positioner in less liquid markets would determine that a block could not be sold to or purchased from others on equivalent or better terms. This appears to be a notion from the liquid, exchange-traded equity markets, in which block positioners can see the prevailing market price and widely disseminated quotes from others. In less transparent markets, market makers face a significant risk that their bids are off-market.

Furthermore, a requirement to sell the instruments composing the block as rapidly as possible is far more damaging in less liquid markets, because rapid disposition of assets can result in fire sales that significantly reduce the price of the asset. Consequently, banking entities will be less willing to facilitate client requests for block trades. If the block positioner provision remains narrow, institutional customers and commercial end users will be unable to find banking entities that are able to facilitate their need to trade in size at a price reasonably related to the market.

## K. Reasonably Expected Near-Term Demands of Clients

**Observation:** The proposed guidance around the “reasonably expected near term demands of clients, customers or counterparties” requirement misconstrues the statutory requirement and does not adequately allow market makers to build and maintain necessary inventory.<sup>131</sup>

The statutory Volcker Rule states that “the purchase, sale, acquisition, or disposition of [what the Proposal refers to as covered financial positions] in connection with . . . market-making-related *activities*” are only allowed “to the extent that any such activities . . . are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.”<sup>132</sup> The Proposal provides that “*a purchase or sale of a covered financial position* shall be deemed to be made in connection with a covered banking entity’s market making-related activities only if . . . the market making-related activities of the trading desk or other organizational unit that conducts *the purchase or sale* are, with respect to *the covered financial position*, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.”<sup>133</sup> The Agencies note that “a banking entity’s expectation should generally be based on the unique customer base of the banking entity’s specific market-making business lines and the near-term demands of those customers based on particular factors beyond a general expectation of price appreciation.”<sup>134</sup>

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<sup>131</sup> We believe this section is responsive to Questions 80, 81, 87, 94 and 184 in the Proposal.

<sup>132</sup> Bank Holding Company Act § 13(d)(1)(B) (as added by Dodd-Frank § 619) (emphasis added).

<sup>133</sup> Proposal § \_\_.4(b)(2)(iii) (emphasis added).

<sup>134</sup> Proposal at 68,871 (FRB 58).

As stated above,<sup>135</sup> this appears to inappropriately recast an activities-based requirement into a transaction-by-transaction requirement. In this particular context, the implied transaction-by-transaction framework, coupled with a narrow interpretation of the permitted activity that focuses on market making rather than market making-related activities, appears to effectively prohibit one of the most important elements of market making—building inventory. Much like a shopkeeper must accumulate inventory on her shelves to meet the demands of her customers, a market maker must collect inventory to be able to meet the demands of its customers. However, like the shopkeeper who does not know who will buy a particular good or when, the market maker does not know that a specific market participant will want the inventory or when. As a result, by moving the “near term demand” factor from an activities-based approach (*i.e.*, allowing the market maker to develop inventory as part of a general activity of making itself able to respond to near term customer demands) to a specific transaction-by-transaction approach (*i.e.*, only allowing the market maker to engage in an inventory-accumulating position if that particular position is entered into in response to near term customer demand), the Proposal appears to effectively prohibit market makers from engaging in a critical market making-related activity.

A market maker’s process for developing appropriate inventory is more difficult than that of a shopkeeper, however, in that the market maker must be prepared not only to sell a covered financial position to a customer, but also to buy a covered financial position from a customer. This is a crucial part of the market maker’s intermediation function, as discussed above.<sup>136</sup> To prepare to do so, the market maker may need to sell short a covered financial position or sell its existing inventory to prepare it to take on positions customers wish to sell. We believe that this concept should be explicitly integrated into the Proposal.

While the commentary on “near term demand” is silent on the question of inventory, the Preamble discussion of the “holding oneself out” requirement states that “*bona fide* market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.”<sup>137</sup> Aside from the fact that this does not, based on its placement in the Preamble, apply to the “near term demand” element of market making, the statement should be revised to clarify that inventory management is an appropriate market making-related activity for a number of reasons. First, the statement limits itself to “securities,” whereas inventory is crucial to market making in all covered financial products. We do not understand why, for example, anticipatory positioning would be allowed in a security-based swap, such as a single name credit default swap, but not in a swap, such as a credit default swap on a broad-based index. Second, the statement is effectively a restatement of the “near term demand” requirement in

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<sup>135</sup> See the discussion beginning on page A-34.

<sup>136</sup> See the discussion beginning on page A-36.

<sup>137</sup> Proposal at 68,871 (FRB 58).

its admonition that the buying and selling activity must be “reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.” As such, even if it were extended to all covered financial positions, the statement could be viewed as removing the discretion of market makers to develop inventory to best serve their customers. We believe such inventory accumulation is clearly “market making-related” as envisioned by Congress in the statutory Volcker Rule, and that this heightened burden of proof exceeds statutory intent.

In markets in which trades are infrequent and customer demand is very hard to predict, it is unclear how a market maker would satisfy the requirement that the market making-related activity be “based on the unique customer base of the banking entity’s specific market-making business lines and the near-term demands of those customers based on particular factors beyond a general expectation of price appreciation.”<sup>138</sup>

This apparent disconnect between the Agencies’ commentary and the realities of the market is contrary to rulemaking requirements under the APA. In interpreting the statutory term “designed not to exceed . . . reasonably expected near term demands,” the Agency must provide a reasoned judgment.<sup>139</sup> As explained above, the restrictive standard suggested by the Preamble, namely, that trades must be “related to clear demonstrable trading interests,” could curtail the market making function and adversely restrict liquidity. By contrast, an interpretation that recognized broadly the need for market participants to position themselves based upon their experience and the exigencies of the market would still impose meaningful restraints, while at the same time better preserving liquidity. This latter interpretation, which better conforms with the statutory framework and is the more reasoned approach, may have been intended by the Agencies. In any event, the Agencies in the final rule should adopt the broader interpretation in order to avoid unduly hampering market-making activities throughout the economy.

The Preamble states that a market maker in an exchange-traded security is acting consistent with reasonably expected near-term customer demand “when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy and the market maker is registered, if the exchange or organized trading facility registers market makers.”<sup>140</sup> We believe there are two problems with this statement. First, the requirement that the market maker only “passively provid[e] liquidity by submitting resting orders” could be read as narrowly limiting the range of trading inherent in market making in exchange-traded instruments. In particular, we believe that market makers need the ability to enter market or marketable limit orders at times to build inventory in connection with positioning a block for

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<sup>138</sup> Proposal at 68,871 (FRB 58).

<sup>139</sup> *State Farm*, 463 U.S. at 43.

<sup>140</sup> Proposal at 68,871 (FRB 59).

a customer or anticipating customer demand as well as respond to movements in prices in the markets. In addition, this distinction may be meaningless in the international context where exchanges are structured differently and may not have the same distinction between limit and market or marketable limit orders.

Second, we believe that the requirement that the market maker be registered with the exchange is problematic and should be removed. Exchanges and organized trading facilities may allow registration of market makers but not require it. As a result, particularly given the large number of exchanges and organized trading facilities for some liquid securities, a trading unit may register as a market maker on one particular, primary exchange but serve, from time to time, in a market making capacity on another for customer demand or other reasons. We see no reason why the market maker should not be able to function as such on other exchanges. We believe this restriction would decrease liquidity and make it harder for market makers to provide their clients with the best possible price, with no corresponding benefit. As a result, we believe that, to the extent a trading unit is registered as a market maker on a particular exchange or organized trading facility for any type of covered financial position, its activities on that exchange or organized trading facility should be presumed to be market making. In addition, we believe that the Proposal's formulation ignores the fact that a market maker may be engaged in activities on one exchange in support of market making on another exchange or in the over-the-counter markets, which is consistent with a market making-*related* permitted activity.

## L. Interdealer Market Making-Related Activities

**Recommendation:** The Agencies should expressly include interdealer market making-related activities within the permitted activity.<sup>141</sup>

We agree with the Agencies' statement that a market maker's "customers" vary depending on the asset class and market in which the market maker is providing intermediation services. For instance, footnote 199 of the Preamble states that, for securities executed on an organized exchange, a customer is a person "on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant" and that, in an over-the-counter market, a customer is "a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services."<sup>142</sup> We believe that these statements allow interdealer market making where brokers or other dealers act as

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<sup>141</sup> We believe this section is responsive to Questions 80, 86, 90, 99 and 100 in the Proposal.

<sup>142</sup> Proposal at 68,890 n.199 (FRB 99 n.199).

customers. However, we feel that the Agencies should expressly incorporate providing liquidity to other brokers and dealers into the rule text.

Interdealer liquidity is critical to the market making function. In many markets, such as the exchange for physical, interest rate swap and foreign exchange options markets, interdealer transactions are particularly important. The liquidity provided by these interdealer transactions allows market makers to intermediate risk for other, non-dealer customers. The FSOC noted the key role of the interdealer market in its study by stating that interdealer transactions are “an important and necessary part of managing the risk exposure of a market maker” and that “[w]hile end users are the ultimate beneficiaries of market making activities, market makers are often forced to trade with non-customers in order to appropriately meet the future expected customer demand.”<sup>143</sup>

To the extent that the definition of “customer” is different between the market making-related permitted activity and the reported quantitative metrics, we are concerned that the quantitative metrics may make legitimate market making-related activity with customers appear to be prohibited proprietary trading. We believe that confusion around interdealer transactions arises in the definition of the Customer-Facing Trade Ratio metric, which defines customer as any counterparty who is not (i) a counterparty to a transaction executed on a designated contract market or national securities exchange or (ii) a broker-dealer, swap dealer, security-based swap dealer, any other entity engaged in market making-related activities, or any affiliate thereof.<sup>144</sup> The metric description does state that entities listed in clause (ii) may be customers “if the covered banking entity treats that entity as a customer and has documented how and why the entity is treated as such,” but does not provide detail around what type of treatment is necessary or what documentation qualifies.<sup>145</sup> We believe that this documentation requirement is unnecessary to achieve the purposes of the section, and that this form of interdealer trading can be easily explained to the Agencies’ examiners.

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<sup>143</sup> FSOC Study at 27.

<sup>144</sup> We discuss the Customer-Facing Trade Ratio in greater detail beginning on page A-110.

<sup>145</sup> Proposal, Appendix A § IV.D.3.

## M. New or Bespoke Products

**Recommendation:** The Agencies should ensure that banking entities can be market makers in new or bespoke products, including structured products and transactions driven by customer requests.<sup>146</sup>

Due to the apparent narrowness of the “on behalf of customers” permitted activity, banking entities will only be able to serve customers as principal in transactions in new and bespoke products (and therefore new markets) if these transactions fit within the market making-related permitted activity. The requirement that such a market maker “hold[] [itself] out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis” would not appear to allow the banking entity to act as an “immediate” market maker in one-off transactions, except perhaps as block positioners. While this problem could be reduced by broadening the “on behalf of customers” permitted activity as per our suggestion below<sup>147</sup> or by substantially expanding the block positioning exception to encompass normal transaction sizes in instruments traded infrequently,<sup>148</sup> we believe that the description of the market making-related permitted activity should be expanded to expressly include transactions in instruments that are new or that occur infrequently, even though a trading unit will not have previously held itself out expressly as being willing to buy and sell the precise covered financial position on a continuous basis. More generally, as discussed above,<sup>149</sup> we believe that trades with a customer focus should fall within the market-making exemption, regardless of whether the trading unit has made markets in that type of instrument with other customers before.

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<sup>146</sup> We believe this section is responsive to Questions 86 and 91 in the Proposal.

<sup>147</sup> See the discussion beginning on page A-80.

<sup>148</sup> Above, we discuss issues with the block positioner commentary in the Proposal, including the fact that it does not account for different block sizes depending on liquidity. See the discussion beginning on page A-40.

<sup>149</sup> See the discussion beginning on page A-37.

## N. Dealer Registration Requirement

**Recommendation:** The Agencies should remove the requirement that a market maker be registered as a dealer or subject to substantive regulation.<sup>150</sup>

With respect to the purchase or sale of securities, swaps or security-based swaps, the Proposal requires that a market maker (i) be registered as a dealer with the SEC or CFTC, as appropriate,<sup>151</sup> or (ii) be “[e]ngaged in the business of a dealer outside of the United States and subject to substantive regulation of such business in the jurisdiction where the business is located.”<sup>152</sup> This requirement does not derive from the statutory Volcker Rule, nor do we believe that such registration is a distinguishing factor between activities engaged in by the banking entity that are market making-related or speculative. To the extent that the Agencies are using this factor to ensure that banking entities are appropriately registered, we believe that the Agencies should rely on existing law and the relevant Commission to determine whether a specific banking entity has the appropriate licenses to conduct its activities.

In addition, we do not believe that market makers in foreign jurisdictions should only qualify for the permitted activity if they are “[e]ngaged in the business of a dealer outside of the United States and subject to substantive regulation of such business in the jurisdiction where the business is located.”<sup>153</sup> We believe this requirement is problematic for

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<sup>150</sup> We believe this section is responsive to Questions 80, 81, 90, 95, 178 and 184 in the Proposal.

<sup>151</sup> Specifically, Section \_\_.4(b)(2)(iv) of the Proposal requires that a market maker be:

(A) With respect to a purchase or sale of one or more covered financial positions that are securities, other than exempted securities, security-based swaps, commercial paper, bankers’ acceptances, or commercial bills: A dealer that is registered with the SEC under Section 15 of the Exchange Act (15 U.S.C. 78o), or a person that is exempt from registration or excluded from regulation as a dealer thereunder; or . . .

(B) With respect to a purchase or sale of one or more covered financial positions that are swaps: A swap dealer that is registered with the CFTC under the Commodity Exchange Act (7 U.S.C. 1a) or a person that is exempt from registration thereunder; or . . .

(C) With respect to a purchase or sale of one or more covered financial positions that are security-based swaps: A security-based swap dealer that is registered with the SEC under Section 15F of the Exchange Act (15 U.S.C. 78o-10) or a person that is exempt from registration thereunder; or . . .

(D) With respect to a purchase or sale of one or more covered financial positions that are municipal securities, a municipal securities dealer that is registered under Section 15B of the Exchange Act (15 U.S.C. 78o-4) or a person that is exempt from registration thereunder; or

(E) With respect to a purchase or sale of one or more covered financial positions that are government securities, a government securities dealer that is registered, or that has filed notice, under Section 15C of the Exchange Act (15 U.S.C. 78o-5) or a person that is exempt from registration thereunder.

<sup>152</sup> Proposal §§ \_\_.4(b)(2)(iv)(A)(2), (B)(2), (C)(2).

<sup>153</sup> Proposal §§ \_\_.4(b)(2)(iv)(A)(2), (B)(2), (C)(2).

a number of reasons. First, market makers may operate in jurisdictions that do not have substantive regulation of dealers but may, for example, act as a registered market maker on an exchange in a manner consistent with the Proposal's requirements. We see no reason why such a market maker should run afoul of the Proposal. Thus, we believe that the market making-related activities of offshore banking entities should qualify for the permitted activity as long as they are engaged in *bona fide* market making-related activities otherwise meeting the permitted activity's requirements. Otherwise, offshore entities located in countries without substantive regulation of specific market activities will be unable to participate and provide liquidity to those markets. We believe that compliance with local regulation, coupled with the market making-related permitted activity requirements in the final regulations, should be sufficient, whether or not local regulations require registration. We do not believe that these requirements should be concerned with whether foreign governments are substantively regulating offshore banking entities.

Finally, in requiring that market makers in swaps be registered as swap dealers with the CFTC and that market makers in security-based swaps be registered with the SEC, this provision incorporates rules that have been proposed but not yet finalized.<sup>154</sup> As discussed above, the definitions of "swap dealer" and "security-based swap dealer" as proposed look to factors not necessarily relevant to what it means to be a market maker in these instruments.<sup>155</sup> In addition, as stated above in the context of the trading account definition,<sup>156</sup> we do not believe that it is procedurally appropriate for a proposed rule to incorporate another proposed rule.

As a result, we recommend that the Agencies eliminate this registration requirement. If the Agencies disagree, we recommend that the requirement be simply an indicative factor of market making activity.

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<sup>154</sup> See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (proposed Dec. 21, 2010); Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 Fed. Reg. 65,784 (proposed Oct. 24, 2011); Registration of Intermediaries, 76 Fed. Reg. 12,888 (proposed Mar. 9, 2011).

<sup>155</sup> See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (proposed Dec. 21, 2010); *see also* the discussion beginning on page A-18.

<sup>156</sup> See the discussion beginning on page A-14.



## O. Arbitrage Activities

**Recommendation:** The market making-related permitted activity should recognize that arbitrage activities, as the Agencies understand them, can constitute market making-related activities.<sup>157</sup>

The Agencies state that “a trading desk or other organizational unit of a banking entity that is engaged wholly or principally in arbitrage trading with non-customers would not meet the terms of the proposed rule’s market making exemption.”<sup>158</sup> We do not believe that this blanket statement is helpful nor does it recognize the many types of customer-focused transactions that may technically constitute arbitrage. “Arbitrage trading,” as that term is used to encompass trading motivated by the differences in prices between two or more instruments, may constitute market making to the extent that it is driven by creating markets for customers tied to that price differential. As a result, we believe that the Agencies should recognize that arbitrage activity may constitute market making, and should not specifically ban arbitrage trading but instead monitor for impermissible patterns of activities through the metrics, compliance and examination tools discussed above.<sup>159</sup>

In many asset classes, customers seek investment opportunities in the relationship between two or more assets, which may be in the same or different asset classes. In commodities derivatives, through “Cash and Carry” or basis trading customers purchase an asset and simultaneously sell a futures or forward contract for delivery of the asset. In this strategy, the customer makes an investment decision on the cost of money and storage facilities rather than making an investment decision on the value of the underlying assets taken separately. Customers may similarly wish to engage in “box” strategies, such as financing transactions based on the fixed value of a combination of four distinct option contracts, and “calendar spreads,” which are investments in implied volatilities between two different months’ options. Similarly, with respect to “merger arbitrage,” customers may ask banking entities to help them invest in the likelihood of completion of a merger at various points in the transaction timeline, rather than the independent value of either company. Such merger arbitrage activity rationalizes the prices of the respective securities and enables customers to transact in the individual instruments and in the paired instruments with assurance that relations between security prices and underlying contracts are held intact. As a part of customer service-oriented market making, banking entities need to be able to engage in this form of arbitrage trading.

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<sup>157</sup> We believe this section is responsive to Questions 86, 90, 91, 94 and 96 in the Proposal.

<sup>158</sup> Proposal at 68,871 (FRB 59).

<sup>159</sup> See the discussion beginning on page A-24.

Furthermore, the demand for some financial instruments is predicated on the fact that the instrument has a specific relationship to another asset or set of assets. Market makers must maintain this relationship in order to serve customer need for the product. For example, as discussed in greater detail below, customers demand ETFs because they allow investment in a basket of underlying financial instruments through an exchange-traded instrument that tracks the value of that basket.<sup>160</sup> Similar concerns apply to American Depository Receipts (“**ADRs**”), which market makers must keep in line with the value of the overseas security, adjusted for currency differences.

It also can be extremely difficult for market makers to respond effectively to customer demands if there is not a transparent market. If market prices are not transparent, market makers will not purchase or sell positions for fear that the purchase or sale will be considered impermissible arbitrage if the mispricing is in the market maker’s favor but will lead to losses if the mispricing is not in the market maker’s favor. The Agencies rightly recognize that arbitrage activity can promote liquidity and price transparency.<sup>161</sup> As a policy matter, therefore, the Agencies should not prohibit arbitrage activity but should view arbitrage across asset classes as a separate asset class in which market makers make prices and hedge their positions in much the same way as a market maker on an exchange does for the common equity of an industrial company.

Moreover, as discussed above,<sup>162</sup> in the modern trading context individual transactions serve multiple purposes. The “wholly or principally” standard raises the practical impossibility of dividing market maker activities into market making, arbitrage, hedging and customer intermediation activities.

We therefore believe that the Agencies should not specifically ban arbitrage trading but rather should monitor for impermissible positions and activities through the metrics, compliance and examination tools discussed above.<sup>163</sup>

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<sup>160</sup> See the discussion beginning on page A-51.

<sup>161</sup> See Proposal at 68,873 (FRB 62).

<sup>162</sup> See the discussion beginning on page A-34.

<sup>163</sup> See the discussion beginning on page A-24.

## P. Foreign Sovereign Debt

**Recommendation:** If foreign sovereign debt is not excluded from the Volcker Rule restrictions, the Agencies must ensure that operations of banking entities in foreign jurisdictions are allowed to meet that jurisdiction’s primary dealer and other requirements.<sup>164</sup>

As discussed below,<sup>165</sup> many banking entities operate in foreign jurisdictions where local branches or agencies of multinational banking entities are required, by local law, to hold or transact in local sovereign debt. For example, some primary dealers are required to take down a specified percentage of any government offering. Below, we argue that foreign sovereign debt should be included within the “government obligations” permitted activity or otherwise exempt from Volcker Rule restrictions to allow these branches or agencies to comply with local law. If this exemption is not granted, the Agencies must ensure that the market making and underwriting permitted activities allow banking entities to engage in these activities, possibly through commentary that fulfilling primary dealer obligations in foreign debt will not be included in determinations of whether the market making exemption applies to a trading unit.

## Q. Exchange-Traded Funds

**Recommendation:** The Agencies should clarify that banking entities can make markets in, and be Authorized Participants for, exchange-traded funds.<sup>166</sup>

The creation, redemption and trading on exchanges of ETFs raise a number of issues under the Proposal that illustrate the threats to significant markets resulting from narrow and inflexible definitions of permitted activities. ETFs are widely regarded as one of the most useful new financial products for retail and institutional investors alike, both inside the United States and abroad. As of November 2011, there were more than 1,000 ETFs in the United States with total net assets greater than \$1 trillion, representing roughly 25 percent of the equity trading volume of U.S. securities exchanges.<sup>167</sup> ETFs offer investors a way to

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<sup>164</sup> We believe this section is responsive to Questions 85, 86 and 90 in the Proposal.

<sup>165</sup> See the discussion beginning on page A-77.

<sup>166</sup> We believe this section is responsive to Questions 85, 86 and 90 in the Proposal.

<sup>167</sup> Investment Company Institute, Exchange-Traded Funds Assets November 2011 (Dec. 29, 2011), available at [http://www.ici.org/etf\\_resources/research/etfs\\_11\\_11](http://www.ici.org/etf_resources/research/etfs_11_11); Journal of Indexes, *Evolving Markets* (Nov./Dec. 2011), at 16.

diversify their portfolios and to cost-effectively hedge their exposures to asset prices and indices. Because of their convenience, low costs and tax advantages they are an attractive means by which investors diversify or express a particular view.

ETF shares are frequently created through principal activities of banking entities. The Proposal could seriously impede these activities, thereby harming the retail and institutional investors that benefit from investing in these funds. ETF shares are created when, often in response to direct customer demand, an “Authorized Participant” (“AP”) provides a basket of financial instruments to a trustee of the fund. The trustee deposits the financial instruments in the fund in exchange for a “creation unit,” a large number of ETF shares. The AP, which is usually a banking entity that would be subject to the Proposal, sells the ETF shares to customers, which may include the initial customer that requested creation of the ETF. While in essence an agency role, for operational reasons these transactions are generally effected as principal. U.S. banking entities represent the large majority of APs in the U.S. market for ETFs.

Once created, the value of the ETF shares stays in line with the net asset value (“NAV”) of the underlying instruments because APs have the ability to constantly create and redeem ETF shares with the fund trustee. If the ETF is trading at a value below NAV, APs will buy ETF shares in the secondary market, redeem them with the trustee and sell the underlying products, bringing the price of the NAV and ETF into alignment. Conversely, if the ETF is trading at a value above NAV, the AP will buy the underlying product and bring it to the trustee to create ETF shares which it will sell in the secondary market. These activities of the AP, therefore, protect investors from the price of an ETF share diverging widely from the price of the underlying assets, helping to make ETFs a desirable investment.

In engaging in these activities, which are critical for the functioning of the ETF market, banking entities are acting in a role that combines underwriting and market making, but does not appear to fit within either of the narrow forms of these permitted activities provided in the Proposal. We share the Investment Company Institute’s concern on this point and refer you to their comment letter on the Proposal.<sup>168</sup> For example, the banking entity may not be able to sell all of the ETF shares it has the trustee create, which may cause a problem under the underwriting permitted activity as the “underwriting” may not be viewed as in response to short-term customer demand. Similarly, implicit in the AP’s role in ETF creation and redemption is price arbitrage, which the Agencies explicitly disavow in the market making-related section of the Proposal.<sup>169</sup> APs may also create ETF shares in order to lend to customers. Although often these transactions are effected for customers, the narrowness of the “on behalf of customers” permitted activity, as currently formulated, appears to be too

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<sup>168</sup> See Letter from Investment Company Institute to the Agencies (Feb. 13, 2012).

<sup>169</sup> See Proposal at 68,871 (FRB 59).

narrow to accommodate all creation and redemption transactions. As a result, we request that the Agencies clarify the treatment of AP activity in the final rules.

In addition to the ETF proprietary trading issues discussed above, we have identified a number of issues that arise with respect to ETFs' treatment under the covered funds provisions of the Proposal. We provide further comment on those issues in our comment letter on covered funds<sup>170</sup> and agree with the comments on those issues in the Investment Company Institute letter.

## **R. Market Making-Related Hedging**

**Recommendation:** Market making-related hedging should not be subject to the risk-mitigating hedging requirements as long as the hedge positions are designed to mitigate the risk of positions acquired through permitted market making-related activities.<sup>171</sup>

The Proposal requires that covered financial positions purchased or sold as part of market making-related hedging be related to market making *and* meet all of the requirements of the risk-mitigating hedging activity.<sup>172</sup> We do not understand why there should be a higher burden to qualify as a hedge under the market making-related permitted activity than under the risk-mitigating hedging permitted activity. In requiring any market making-related hedge to meet the full set of risk-mitigating hedging requirements, we believe that this provision misconstrues the statutory Volcker Rule's market making-*related* permitted activity.<sup>173</sup> As a result, we believe that a transaction in a covered financial position should fall within the market making-related permitted activity as long as it mitigates the risk associated with positions acquired through permitted market making-related activities, without reference to the hedging requirements.

Market makers are willing to act as intermediaries in covered financial positions, in part, because of their ability to risk manage their market making activities on an aggregate level. The Proposal's apparent transaction-by-transaction approach to the market making-related and risk-mitigating hedging permitted activities does not recognize that hedge positions are indistinguishable from non-hedge positions. A stylized example of trading in financial instruments under which a trading unit enters into a position and then takes another

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<sup>170</sup> See Section VI.C(a) of the Joint Covered Funds Letter.

<sup>171</sup> We believe this section is responsive to Question 98 in the Proposal.

<sup>172</sup> Proposal § \_\_.4(b)(3).

<sup>173</sup> See the discussion beginning on page A-29.

position to hedge the risks of the first does not reflect the complex way in which market making, or any other, portfolios are managed. Instead, every instrument in a portfolio contributes to the risk profile of that portfolio. Portfolio risk is managed holistically as trading units use multiple products as part of a dynamic process through which they assess how any particular transaction will change the composition of the portfolio. In other words, while the Proposal recognizes portfolio hedging,<sup>174</sup> which refers to hedging the risk of an entire portfolio, it does not recognize that risk mitigation is a *function* of the entire portfolio rather than specific hedge instruments that mitigate the risk of non-hedge instruments.

For example, a market maker in corporate bonds may use the bonds themselves, other bonds of the same issuer or different issuers, equity securities, interest rate contracts, futures and forwards contracts or credit default swaps as part of an overall strategy to provide liquidity to customers. The market maker uses these instruments interchangeably, viewing each as a bundle of risks that contribute to the risk profile of the portfolio. As customers make requests of the market maker, the risk profile of the portfolio changes. For example, a customer's purchase of a bond may decrease one risk of the portfolio but increase another, such as decreasing credit risk to a particular issuer but increasing volatility risk. In deciding how to fill the next customer's order, the market maker will keep this new risk calculus in mind. As portfolio management becomes more efficient, it becomes harder to categorize a transaction as hedging, market making, arbitrage or something else.

Furthermore, as a safety and soundness policy matter, we think that the Agencies should encourage, not discourage, appropriate market making-related hedging. Hedging is a necessary and desirable part of the market making process. Impediments to hedging market making-related positions will decrease banking entities' willingness to make markets and, therefore, liquidity. In fact, Appendix B indicates that appropriate risk management, including through hedging, is an indicator of market making-related activity.<sup>175</sup>

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<sup>174</sup> While we appreciate the Proposal's explicit acceptance of portfolio hedging, we believe that, as discussed below, the specific requirements of the permitted activity do not reflect the realities and critical role of portfolio hedging. *See* the discussion beginning on page A-72.

<sup>175</sup> Proposal Appendix B § III.C; *see also* § III.A (“The primary purpose of market making-related activities . . . is *not* to earn profits as a result of movements in the price of positions and risks acquired or retained; rather a market maker generally manages and limits the extent to which it is exposed to movements in the price of principal positions and risks that it acquires or retains . . . [and] will eliminate some or all of the price risks to which it is exposed.”).

### III. Underwriting Permitted Activity

#### A. In Connection with a Distribution

**Recommendation:** The word “solely” should be removed from the “in connection with a distribution” prong of the underwriting permitted activity.<sup>176</sup>

The third criterion for the underwriting permitted activity requires that the “purchase or sale [must be] effected *solely* in connection with a distribution of securities for which the covered banking entity is acting as underwriter.”<sup>177</sup> We believe that the word “solely” as used in this context goes beyond the requirements of the statute and could result in the Agencies interpreting the underwriting permitted activity in a manner that is unnecessarily narrow, as well as result in market disruption. Removing the word solely would provide comfort that existing syndicate and other activities to facilitate, support, and manage the offering process are within the scope of the permitted activity, which we believe is consistent with the Agencies’ intention.<sup>178</sup>

We are concerned, however, that certain activities that are important, but not always necessary, for a successful offering, might not be viewed by regulators as being effected *solely* in connection with a distribution.<sup>179</sup> For example, underwriters typically create a syndicate short position in connection with an offering (*i.e.*, the sale of securities for the account of the syndicate equal to or in excess of the number of additional securities included in the firm commitment underwriting), which, in the case of equities, may be covered (because the underwriters have the option to purchase additional securities from the issuer) or naked (because the underwriters must cover the short by purchasing shares from the open market), and in the case of debt, would be naked. The reason for creating the short positions (covered and naked) is to facilitate an orderly aftermarket and to reduce price volatility of the newly offered securities. This provides significant value to issuers and selling security holders, as well as to investors, by giving the syndicate buying power that helps protect against immediate volatility in the aftermarket. Underwriters may also engage in stabilization activities under Regulation M by creating a stabilizing bid to prevent or slow a decline in the market price of a security. These activities should be encouraged rather than

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<sup>176</sup> We believe this section is responsive to Questions 64, 65, 69 and 71 in the Proposal.

<sup>177</sup> Proposal § \_\_.4(a)(2)(iii) (emphasis added).

<sup>178</sup> See Proposal 68,925 (FRB 49) (“The Agencies anticipate that the proposed approach to implementing the underwriting exemption should permit legitimate forms of underwriting in which market participants currently engage and, thus, should not unduly burden capital formation.”).

<sup>179</sup> Note that the examples discussed in this section are not an exclusive list of the types of transactions that we believe should be viewed to be “in connection with a distribution.”

restricted by the Volcker Rule because they reduce price volatility and facilitate the orderly pricing and aftermarket trading of underwritten securities, thereby contributing to capital formation.

It is also unclear whether the underwriting permitted activity, as proposed, is broad enough to encompass a variety of derivatives transactions between an issuer or selling security holder and an underwriter or its affiliate that are designed to help issuers and selling security holders raise capital. For example, in a convertible debt offering, an underwriter or its affiliate may enter into call spread options with an issuer to mitigate the dilution of the issuer's existing shareholders upon conversion of the notes, and the underwriter or its affiliate may hedge its exposure on the call spread by selling shares short in the market.

Underwriters (and their affiliates), issuers and selling security holders also enter into transactions such as interest rate locks to mitigate losses in connection with investment grade bond offerings, stock borrow facilities to fulfill settlement obligations, and forward sales of stock to finance an acquisition that will close in the future. These transactions provide various benefits to issuers and selling security holders and are an integral part of the overall package that an issuer or selling security holder considers in determining whether to conduct an offering. For example, where an interest rate lock is available, when a chief financial officer of an issuer considers whether to do an offering, such officer considers the costs of the capital raise net of the cost-mitigating impact of the interest rate lock. If the interest rate lock were not available, the issuer may not be able to do the offering because the costs of capital would be too high. The decision of whether to issue securities, therefore, often cannot be severed from the decision to enter into an accompanying derivative transaction.

Another example of an underwriting transaction where a derivative is central to the transaction is a prepaid forward. In a prepaid forward transaction, the seller enters into a forward sale agreement with a banking entity pursuant to which it agrees to deliver securities to the banking entity at a future date. At the time of entering into this forward sale, the banking entity (or an affiliate thereof) will borrow and sell securities to hedge its exposure. In these cases, the forward sale and associated hedging activity are integral to the underwriting. Another example occurs when underwriter backstops a rights offering (agreeing to exercise any rights that are not exercised by shareholders) and may hedge its exposure by selling the issuer's stock or rights short and, as a means of covering such short sales, may purchase from shareholders (and subsequently exercise) rights that were previously issued (but not yet exercised) in the rights offering. The underwriting permitted activity should be construed broadly enough to capture these activities and the associated hedging.

Inclusion of the word "solely" creates unnecessary ambiguity regarding the permissibility of activities that are critical to the capital formation process. Therefore, we recommend that the Agencies remove the word "solely" from the "in connection with a distribution" prong of the underwriting permitted activity.



## B. Near-Term Demands of Clients

**Recommendation:** The Agencies should interpret the “near term demands of clients” prong flexibly to accommodate capital formation.<sup>180</sup>

The underwriting activities of banking entities must be “designed not to exceed the reasonably expected near term demands of clients.”<sup>181</sup> While we support the Preamble’s recognition that residual positions may arise in connection with underwriting,<sup>182</sup> we are concerned that absent clarity or specific guidance, banking entities may be discouraged from engaging in underwritings where there is a potential risk of a residual position—including transactions that may be necessary for corporations and other entities to raise capital—out of concern that the Agencies could question legitimate transactions with the benefit of hindsight.

For example, while in many transactions the banking entity is able to build a book of orders before committing to purchase the securities from the issuer or selling security holder, there are many transactions where that is not the case. In a bought deal, the banking entity acts as principal and commits to purchase securities from an issuer or selling security holder without engaging in a full book-building because of the issuer’s or selling security holder’s desire for speed and certainty of execution. In this context, there is a greater risk that the banking entity will end up with an unsold position. This may occur, for example, where the price of the security declines after the banking entity has agreed to purchase it, therefore making it economically impractical for the banking entity to fully divest the purchased securities in the near term. Similarly, in rights offerings, which are common outside the United States and have in recent years been used by many banking organizations to raise equity capital, the issuer generally seeks assurance that all the rights will be exercised and the maximum amount of proceeds will be raised. The underwriter generally backstops the offering, assuming the risk that investors will not exercise all the rights, and may wind up with a residual position in the event that investors do not exercise all the rights.

We believe the Agencies should provide in the adopting release that the near-term demands prong will be interpreted flexibly for purposes of the underwriting permitted activity. This is important to provide efficient pricing for issuers and selling security holders and to provide the most expansive set of capital raising options to issuers and selling security holders. If banking entities believe that unsold allotments from underwritings will subject

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<sup>180</sup> We believe this section is responsive to Questions 65, 67 and 73 in the Proposal.

<sup>181</sup> Proposal § \_\_.4(a)(2)(v).

<sup>182</sup> See Proposal at 68,867 (FRB 49). In any underwriting, including those where a banking entity carefully builds its book before agreeing to purchase securities from an issuer or selling security holder, there is a risk of residual positions. It is important that the presence of such risk not preclude a banking entity from taking advantage of the underwriting permitted activity.

them to second-guessing by the Agencies, they will either be less likely to engage in underwritings where there exists a potential risk of unsold allotments, or they will price this risk into the fees they charge their underwriting clients. In either case, the result will be significantly higher costs of, and limited opportunities for, capital formation, thereby foreclosing an important source of funding for the operations of U.S. companies and other sellers in the capital markets. More generally the Agencies should recognize that underwritings are, by nature, customer-driven transactions and the size of the underwriting is dependent upon the needs of the customer and issuer. The Volcker Rule was not intended to curtail servicing the needs of the customer.

### C. Focus on Regulation M Distributions

**Recommendation:** The focus on Regulation M distributions in the definition of underwriting would preclude certain *bona fide* underwriting activities. The definition of distribution should be expanded to not require “magnitude” and to explicitly include any offering of securities by an issuer and any offering by a selling shareholder that is registered under the Securities Act or that involves an offering document prepared by the issuer.<sup>183</sup>

The proposed rule text incorporates the definition of distribution from Regulation M for purposes of defining the underwriting permitted activity.<sup>184</sup> While the definition of distribution in Regulation M covers the majority of underwriting activities of banking entities, it does not cover all *bona fide* underwritings. A “distribution” for Regulation M purposes requires both “magnitude” and “special selling efforts.”<sup>185</sup> Accordingly, an offering that is too small to meet the “magnitude” prong (generally considered in most cases to be less than 1% of the outstanding class) would not be a “distribution” and therefore would not be a permissible underwriting activity. Although the Preamble states that the “magnitude” prong of the definition of “distribution” does not preclude small offerings or private placements from qualifying for the underwriting exemption,<sup>186</sup> we do not believe this interpretation is consistent with the traditional analysis for determining whether an offering qualifies as a “distribution” under Regulation M. We believe the Agencies should explicitly state in the rule text that an offering will qualify as a

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<sup>183</sup> We believe this section is responsive to Questions 64, 65, 69 and 71 in the Proposal.

<sup>184</sup> The Agencies note that the Proposal’s definition of “distribution,” *see* Proposal § \_\_.4(a)(3), is “generally identical to” the definition of distribution in the SEC’s Regulation M. *See* Proposal at 68,866-67 (FRB 48).

<sup>185</sup> 17 C.F.R. § 242.100(b).

<sup>186</sup> Proposal at 68,867 (FRB 49).

distribution regardless of whether there is magnitude.<sup>187</sup> The presence of special selling efforts is sufficient to distinguish an offering from ordinary secondary market trading activity.

The definition of distribution should also be expanded to include (i) any offering of securities by an issuer and (ii) any offering by a selling shareholder that is registered under the Securities Act of 1933 or that involves an offering document prepared by the issuer. This is important in order for certain offerings that do not involve “special selling efforts” to qualify for the underwriting permitted activity. These types of transactions include, for example, an offering of securities by an issuer or a selling security holder where securities are sold through an automated order execution system, offerings in response to reverse inquiries and commercial paper issuances. These offerings are legitimate financing and capital-raising activities and are clearly distinguishable from ordinary secondary market trading activity.

#### **D. Bridge Loans**

***Recommendation:*** The Agencies should provide greater clarity around the treatment of securities issued in lieu of or to refinance bridge loans.<sup>188</sup>

We are concerned that that the Proposal would make it more difficult for corporate borrowers to obtain bridge loans from banking entities. Specifically, we are concerned that the customary manner in which securities are issued in lieu of or to refinance bridge loans could be deemed to be prohibited proprietary trading that does not fall within the underwriting permitted activity. Many of our members are members of the Loan Syndications and Trading Association (the “LSTA”). We fully support the recommendations set forth in the LSTA’s letter to the Agencies with respect to the treatment of securities issued in lieu of or to refinance bridge loans.<sup>189</sup>

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<sup>187</sup> The Agencies could do so by removing the words “the magnitude of the offering” from the proposed definition of distribution in §\_\_4(a)(3).

<sup>188</sup> We believe this section is responsive to Questions 67, 73, 76 and 79 in the Proposal.

<sup>189</sup> See Letter from the LSTA to the Agencies (Feb. 13, 2012).

## E. Current Market Practices

**Recommendation:** The Agencies should expand the definition of underwriter to reflect current market practices.<sup>190</sup>

We believe that the definition of “underwriter” proposed by the Agencies is too narrow. The definition would exclude dealers that participate in an underwriting but do not deal directly with the issuer or selling security holder (as might occur, for example, in the case of selling dealer groups).<sup>191</sup> To avoid this result, we recommend that the Agencies either (i) define “underwriter” in accordance with the definition of “distribution participant” as defined in Regulation M, or (ii) replace the term “underwriter” in proposed Section \_\_.4(a)(2)(iii) with the term “distribution participant” and define “distribution participant” consistently with the Regulation M definition. The Regulation M definition of “distribution participant” includes an “underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution,” where the definition of “distribution” is modified to reflect our comments discussed in the second preceding section above.<sup>192</sup> We believe that revising the underwriting permitted activity to include such distribution participants would best effectuate the Agencies’ intention to allow selling group members that distribute securities to avail themselves of the underwriting permitted activity.<sup>193</sup> This is important to accommodate the full range of distribution arrangements that issuers depend on to raise capital.

If the Agencies do not adopt our suggestion to expand the definition of underwriter in the manner discussed above, we believe that at a minimum the Agencies should amend proposed Section \_\_.4(a)(4)(i) to include within the definition of underwriter a person who has agreed with an *affiliate* of an issuer or of a selling security holder to engage in a distribution (where the definition of “distribution” is modified to reflect our comments above) for such issuer or selling security holder. The recommended change in Section \_\_.4(a)(4)(i) would avoid any ambiguity regarding whether a banking entity can avail itself of the exception for underwriting when it enters into an agreement with an affiliate of an issuer, such as a parent company, to distribute the issuer’s securities. The Agencies should further clarify in Section \_\_.4(a)(4)(ii) that a person is acting as an underwriter if such person has an

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<sup>190</sup> We believe this section is responsive to Questions 67 and 72 in the Proposal.

<sup>191</sup> The Agencies proposed to adopt a modified version of the Regulation M definition of underwriter that includes a person that has not dealt directly with the issuer or the selling security holder but has an agreement with an underwriter for the issuer or selling security holder. This definition would not encompass selling dealers that do not have a written agreement with an underwriter. *See* Proposal § \_\_.4(a)(4); Proposal at 68,867 (FRB 49); 17 C.F.R. § 242.100(b).

<sup>192</sup> 17 C.F.R. § 242.100(b).

<sup>193</sup> *See* Proposal at 68,867 (FRB 49).

agreement with an issuer or selling security holder, or affiliate thereof, to *participate in* a distribution of securities, *or such person is participating in* a distribution of securities. This change would make Section \_\_.4(a)(4)(ii) consistent with the definition of underwriter in Section \_\_.4(a)(4)(i)(C).

## IV. Risk-Mitigating Hedging Permitted Activity

### A. General Approach to Risk-Mitigating Hedging

**Recommendation:** The permitted activity should consist of a general statement that risk-mitigating hedging is permitted and encouraged, with the current hard-coded criteria moved to become guidance and a requirement that banking entities adopt risk limits and policies and procedures commensurate with the Agencies' guidance. The Agencies would review risk-mitigating hedging through metrics and examinations.<sup>194</sup>

In allowing banking entities to engage in risk-mitigating hedging, Congress recognized, as expressed by the FSOC, that “prudent risk management is at the core of both institution-specific safety and soundness, as well as macroprudential and financial stability.”<sup>195</sup> We strongly believe that an overly narrow risk-mitigating hedging permitted activity, based on hard-coded criteria that may not apply to all valid hedging, is not only contrary to congressional intent, but also will significantly harm the safety of banking entities, their clients and the financial system as a whole. In addition, by limiting banking entities' ability to hedge customer-driven exposures, the Proposal would make it harder for banking entities to provide financial products to their customers that the customers, in turn, use to hedge their own risks. As a result, systemic risk could increase, rather than decrease. We believe a rule that construes the risk-mitigating hedging permitted activity in this way would contravene congressional intent underlying Dodd-Frank.<sup>196</sup>

As a result, we believe that the risk-mitigating hedging permitted activity requirements should take the form of a general statement that risk-mitigating hedging is not only permitted but encouraged,<sup>197</sup> with guidance in the adopting release that considers the full extent of risk-reducing hedging and presents factors, such as the level of correlation, useful in monitoring hedging techniques. As in the market making-related context,<sup>198</sup> we believe that

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<sup>194</sup> We believe this section is responsive to Questions 102, 103, 106, 107, 110 and 111 in the Proposal.

<sup>195</sup> FSOC Study at 20.

<sup>196</sup> The Supreme Court has emphasized that it is necessary to view a statutory provision in light of other related statutory provisions, not only in isolation. *United Savings Assoc. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988) (“Statutory construction . . . is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear, . . . or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law.”).

<sup>197</sup> We do not believe, however, that a formal definition of “risk-mitigating hedge” should be provided. The many forms that risk-mitigating hedging takes would make any such definition underinclusive.

<sup>198</sup> See the discussion beginning on page A-24.

banking entities should be required to incorporate the guidance into policies and procedures to monitor the safety, soundness and appropriateness of hedging. Trading units should also be required to stay within risk limits determined and applied by the banking entity. Trades entered into to mitigate risk, including portfolio hedging and dynamic hedging as are currently allowed in the Proposal, should be presumed to be appropriate hedges unless determined otherwise.<sup>199</sup>

In using this regulatory scheme, the Agencies would be able to rely on and leverage their existing risk management requirements. For example, under the Market Risk Capital Rule, banking entities that engage in significant amounts of market trading must maintain risk management systems that are “independent from business trading units,” “integrated into the daily management process,” and subject to “independent review . . . at least annually.”<sup>200</sup> Similarly, a banking entity required to use internal credit risk models to calculate its regulatory capital requirements must have “an appropriate infrastructure with risk measurement and management processes . . . given the [banking entity’s] size and level of complexity.”<sup>201</sup> Furthermore, under the CAMELS rating system, federal banking regulators evaluate a banking entity in part based on “[t]he capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution’s activities.”<sup>202</sup> For example, when evaluating a bank holding company’s risk management systems, bank examiners are instructed to look to whether the bank holding company has in place “validation efforts [that are] conducted by individuals who have proper levels of organizational independence and expertise.”<sup>203</sup> Finally, the CFTC and SEC have proposed comprehensive risk management systems for swap dealers and security-based swap dealers<sup>204</sup> to complement their regulation of futures commission merchants, broker-dealers and other regulated intermediaries.

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<sup>199</sup> This is in contrast to Appendix B, which in many cases defines market making based on what it is not. See the discussion beginning on page A-23.

<sup>200</sup> See 12 C.F.R. pt. 3 app. B § 4(b) (for national banks); 12 C.F.R. pt. 225 app. E § 4(b) (for bank holding companies); 12 C.F.R. pt. 325 app. C § 4(b) (for insured state nonmember banks).

<sup>201</sup> See 12 C.F.R. pt. 3 app. C § 22(a)(3) (for national banks); 12 C.F.R. pt. 225 app. G § 22(a)(3) (for bank holding companies); 12 C.F.R. pt. 325 app. D § 22(a)(3) (for insured nonmember banks).

<sup>202</sup> Federal Financial Institution Examination Council, Uniform Financial Institutions Rating System, 61 Fed. Reg. 67,021, at 67,027 (Dec. 19, 1996).

<sup>203</sup> Bank Holding Company Supervision Manual § 2124.0.2.5; see also FDIC, Risk Management Manual of Examination Policies (2004); OCC, Bank Supervision Process: Comptroller’s Handbook (2007).

<sup>204</sup> See Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 Fed. Reg. 71,397 (proposed Nov. 23, 2010); Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants, 75 Fed. Reg. 71,391 (proposed Nov. 23, 2010); Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 76,666 (proposed Dec. 9, 2010); Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 81,519 (proposed Dec. 28, 2010); Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap (...continued)

In addition, the Agencies would leverage the policies and procedures already developed by banking entities that require hedging of risk and govern how that hedging must occur, but provide sufficient latitude for unforeseen circumstances where risks may need to be hedged rapidly in new ways. These policies generally include risk limits for trading units. The Agencies should encourage this type of sound risk management by banking entities and should not chill legitimate hedging activity through uncertainty about whether a particular hedge meets the specific requirements of a prescriptive rule.

We believe that all of the guidance should include qualifiers for the “facts and circumstances” of particular hedges, a qualifier currently limited to the correlation<sup>205</sup> and continuing review of correlation<sup>206</sup> hard-coded requirements in the permitted activity. This qualifier is equally appropriate in other hedging contexts. It should be added to the specific risk hedging,<sup>207</sup> new significant exposures<sup>208</sup> and compensation<sup>209</sup> provisions, as well as to the remainder of provisions governing ongoing review of hedging activities. As discussed in detail below,<sup>210</sup> unique risk circumstances may require new types of hedging strategies. The Agencies should provide for firms to be able to hedge effectively, and the Agencies should be able to analyze the facts and circumstances of any hedges they choose to examine further.

## **B. Non-Market Making-Related Hedging**

**Recommendation:** The permitted activity should focus on non-market making-related hedging, leaving market making-related hedging to the market making-related permitted activity.<sup>211</sup>

The statutory Volcker Rule allows banking entities to engage in “risk-mitigating hedging activities in connection with and related to individual or aggregated

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(continued...)

Participants, 76 Fed. Reg. 6,715 (proposed Feb. 8, 2011); Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 6,708 (proposed Feb. 8, 2011); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (proposed Apr. 28, 2011).

<sup>205</sup> Proposal § \_\_.5(b)(2)(iii).

<sup>206</sup> Proposal § \_\_.5(b)(2)(v)(B).

<sup>207</sup> Proposal § \_\_.5(b)(2)(ii).

<sup>208</sup> Proposal § \_\_.5(b)(2)(iv).

<sup>209</sup> Proposal § \_\_.5(b)(2)(vi).

<sup>210</sup> See the discussion beginning on page A-66.

<sup>211</sup> We believe this section is responsive to Questions 102 and 103 in the Proposal.



positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.”<sup>212</sup> This permitted activity is separate from market making-related permitted activity.<sup>213</sup> As discussed above,<sup>214</sup> we believe that market making-related hedging is a critical part of market making-related activity and, as a result, should be explicitly permitted by the Agencies as part of that permitted activity.<sup>215</sup>

We believe that the risk-mitigating hedging permitted activity is meant to allow banking entities to engage in risk-mitigating behavior beyond the market making context. For example, a banking entity may engage in activities to mitigate the risk of its loan book or put on scenario hedges to protect against remote but potentially devastating market events. Such non-market making-related hedging is critical to the safety and soundness of a banking entity and, by extension, to the financial markets as a whole.

As discussed in further detail below, we believe that the risk-mitigating hedging permitted activity, as implemented in the Proposal, does not clearly encompass the full breadth of transactions that banking entities enter into outside the market making context to hedge or mitigate their risks. We emphasize the difference between market making-related and non-market making-related hedging because we believe the current formulation of the hedging permitted activity is based on a stylized example of hedging in the market making context that does not clearly include all aspects of market making-related hedging, much less hedging outside of that context.

Moreover, we believe that the risk-mitigating hedging permitted activity should not be a transaction-by-transaction analysis. The rule text states that “the prohibition on proprietary trading . . . does not apply to the purchase or sale of *a covered financial position* by a covered banking entity that is made in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity and is designed to reduce the specific risks to the covered banking entity in connection with and related to such positions, contracts, or other holdings.”<sup>216</sup> The key individual provisions of the Proposal seem to require that “*the purchase or sale*” meets specific criteria.<sup>217</sup> As stated above,<sup>218</sup> we believe that this would contravene congressional intent that the permitted

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<sup>212</sup> Bank Holding Company Act § 13(d)(1)(C) (as added by Dodd-Frank § 619).

<sup>213</sup> Bank Holding Company Act § 13(d)(1)(B) (as added by Dodd-Frank § 619).

<sup>214</sup> See the discussion beginning on page A-53.

<sup>215</sup> We note, and agree with, the request made in the Joint Covered Funds Letter that a single risk-mitigating hedging permitted activity, as revised in light of our comments in this and that letter, should apply to both the proprietary trading and covered funds portions of the final Volcker Rule regulations.

<sup>216</sup> Proposal § \_\_.5(a).

<sup>217</sup> Proposal § \_\_.5(b).

<sup>218</sup> See the discussion beginning on page A-34.

activities be viewed on an activity-wide level, which was expressed in the risk-mitigating hedging context by the statutory text allowing banking entities to engage in “risk-mitigating hedging activities.”<sup>219</sup>

Finally, as stated in our letter on the covered fund provisions of the Proposal,<sup>220</sup> we believe that the Agencies have ignored the single statutory hedging exemption that is applicable to both proprietary trading and covered funds prohibitions in favor of two distinct exemptions. We believe this inappropriately singles out the covered fund asset class and that, as a result, the hedging permitted activity with the modifications discussed in this letter should also be applicable to investments in covered funds for hedging purposes.

### C. Reasonable Correlation

**Observation:** Requiring that a hedging position be “reasonably correlated” to the risk hedged, rather than including correlation as one indicator of hedging activity, could limit valid risk-mitigating hedging activities.<sup>221</sup>

The risk-mitigating hedging permitted activity requires that any hedging transaction be “reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate.”<sup>222</sup> The Preamble discussion of this factor demonstrates the difficulty of determining what constitutes reasonable correlation.<sup>223</sup> We believe that this requirement, like the other hard-coded market making criteria, should instead be provided as guidance. However, we believe that any such guidance should be modified to reflect the fact that some transactions that are valid hedges may only be correlated with the risk they are meant to mitigate in extreme circumstances that would not, at the inception of the transaction, be captured by the correlation statistic.

Correlation is backward-looking—it measures the historical joint movements of instruments in an attempt to predict the future relationship between them. In many cases, this prediction is likely to be accurate, and correlation is an appropriate way to determine whether an instrument is a good hedge of a given risk. In some cases, however, a prediction based on past events may not be appropriate, and a risk manager with knowledge of the

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<sup>219</sup> Bank Holding Company Act § 13(d)(1)(C) (as added by Dodd-Frank § 619) (emphasis added).

<sup>220</sup> See Section VI.D of the Joint Covered Funds Letter.

<sup>221</sup> We believe this section is responsive to Questions 105, 106, 107, 109 and 110 in the Proposal.

<sup>222</sup> Proposal § \_\_.5(b)(2)(iii).

<sup>223</sup> See Proposal at 68,875 (FRB 66-67).

financial markets may foresee that a specific instrument may usefully offset an extreme or previously unknown risk. For example, trading units enter into scenario hedges to mitigate the risk of unlikely “tail” events that might otherwise have a devastating impact on the trading unit. Scenario hedging, due to the significant but infrequent risk it is trying to mitigate, requires knowledgeable risk managers to consider how major infrequent events might affect various markets.<sup>224</sup> The instruments used for scenario hedges may not have high correlation with movements in the price of assets in normal times. As a result, at inception they may appear to be weakly correlated with the risk and not appropriate for purposes of the permitted activity. Such hedges, however, are critical to ensuring that particularly problematic scenarios do not jeopardize the stability of the financial institution. As a result, we believe that correlation should not be a hard-coded factor, but instead should be guidance regarding risk-mitigating hedging. The Agencies should also specifically recognize that certain tail risk hedges may be only loosely correlated at inception but nonetheless are the most effective hedge available against a catastrophic tail risk event.

To the extent correlation is used by the Agencies as a proxy for the quality of a hedge, we strongly agree with the Agencies that a transaction relying on the hedging exemption should not need to be fully correlated with the risk it is intended to hedge and that the degree of correlation will vary depending on the underlying risks and the availability of alternative hedging options.<sup>225</sup> Yet, we find problematic the Agencies’ next statement that “risks that can be easily and cost-effectively hedged with extremely high or near-perfect correlation would typically be expected to be so hedged.”<sup>226</sup> This statement creates uncertainty as to whether a specific hedge has “extremely high or near-perfect correlation” to a given risk, or whether an alternative hedge may be later viewed as sufficiently cost-effective to call into question the hedge that was used at the beginning of the transaction. We believe such hedging decisions should be within the discretion of the banking entities, subject to reasonable policies, procedures and compliance monitoring.

We also disagree with the concept in the Proposal that a proper risk-mitigating hedge may be viewed as impermissible proprietary trading if the hedge results in appreciable profits.<sup>227</sup> We agree that banking entities should not be able to characterize a transaction entered into primarily for speculative purposes as a risk-mitigating hedge. However, we believe that the risks of inappropriate positioning for the purpose of profiting from price

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<sup>224</sup> At a time when the Board is requiring banking entities to perform stress tests based on scenarios, it is anomalous that a regulation would prohibit banking entities from hedging against scenario risk. *See* Nassim Nicholas Taleb, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* (2007).

<sup>225</sup> Proposal at 68,875 (FRB 66).

<sup>226</sup> Proposal at 68,875 (FRB 66).

<sup>227</sup> *See* Proposal at 68,875 (FRB 66).

changes can be addressed through policies and procedures, metrics and supervisory monitoring, as discussed above.<sup>228</sup>

It is not necessary to cast doubt on *bona fide* hedging transactions based on whether they might, over the duration of the hedge, generate profits. Rather, the proper focus should be on the purpose for entering into the transaction (*i.e.*, whether it was entered into principally for hedging purposes, with any potential profits being an incidental outcome of such purpose, or it was entered into principally for speculative purposes). If a banking entity is able to demonstrate that it entered into a hedge principally to mitigate risks, the fact that the organization hedges its risks in a manner that also provides incidental profits to the organization *promotes*—rather than jeopardizes—the safety and soundness of the entity.

#### **D. No New Significant Risks at Inception**

***Recommendation:*** The “no new significant risks at inception” requirement does not appear to recognize that all hedging activity subjects the banking entity to new, possibly significant risks. Instead, the guidance should incorporate the Agencies’ idea that basis and credit risks, among other risks, may occur as part of valid hedging.<sup>229</sup>

The hedging permitted activity requires one hard-coded factor that risk-mitigating hedging not give rise to significant new, non-hedged risks at inception.<sup>230</sup> We believe that this requirement misapprehends the complexity of hedging. It appears to assume that hedging positions decrease risk along all dimensions, whereas most hedging reduces risk on one dimension while often raising risk to a lesser extent along another dimension.

This occurs because a trading unit in one instrument frequently hedges using other instruments. This is particularly likely in less liquid markets where, by definition, it is difficult for the banking entity to find a trade identical to the one it is looking to hedge. If they could, clients would do so themselves. As a result, risks arising from one type of instrument are hedged with another instrument or basket of instruments, which results in some amount of basis risk. For example, a unit trading less liquid equities may hedge its exposure through correlated liquid equities and options. This exposes the trading unit to basis risk,

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<sup>228</sup> Question 106 asks how any burden can be “minimized or eliminated in a manner consistent with the language and purpose of the statute.” We believe that eliminating this factor will avoid the unnecessary burden of determining what fits into a vague “reasonable correlation” framework. See the discussion beginning on page A-62.

<sup>229</sup> We believe this section is responsive to Questions 107 and 111 in the Proposal.

<sup>230</sup> Proposal § \_\_.5(b)(2)(iv).

including dividend-related risk, even though the trade may demonstrably reduce the market risk of the trading unit. Similarly, a banking entity may help an insurance company hedge its risk of declining interest rates by writing call options on U.S. Treasuries to the insurance company.<sup>231</sup> To hedge its exposure under the option, the banking entity may hedge in an S&P 500 index instrument, which can be correlated to interest rates in times of market disruptions. However, under this scenario, basis risk arises for the banking entity in case the S&P 500 does not move commensurate with interest rates.

Similarly, any swap, security-based swap or futures contract subjects the banking entity to credit risk. In an uncleared transaction, the credit risk exists as to the counterparty directly; if the counterparty defaults, the banking entity may not receive the value of its position. Even in a cleared transaction, though more remote, more concentrated credit risk to the clearinghouse exists. Particularly in bilateral transactions, this credit risk may be significant.

The Agencies do recognize the existence of basis and counterparty credit risks. The Preamble helpfully acknowledges that hedging transactions “will inevitably give rise to certain types of new risk, such as counterparty credit risk or basis risk reflecting the differences between the hedge position and the related position.”<sup>232</sup> However, the Proposal seeks to solve this problem by noting that the “proposed criterion only prohibits the introduction of additional *significant* exposures through the hedging transaction.”<sup>233</sup> This does not fully reflect that the basis and counterparty credit risk may itself be significant. In fact, intermediating these risks are a core part of what banking entities do and why other market participants are willing to compensate them for their services.

The “no new significant risks at inception” requirement, and particularly its condemnation of underhedging, fails to fully recognize that all risks may not be able to be hedged on a cost-effective basis. In the extreme, dynamic hedging is generally based on continuous time mathematical models. Requiring hedging in continuous or near-continuous time is impracticable and would raise the transaction costs and make the hedge uneconomic. While we understand that the Agencies wish to guard against trading units that use risk-mitigating hedging as a disguise for prohibited proprietary positions, such as through purposeful speculative overhedging, we believe that such a concern is better addressed by the Agencies through the combination of policies and procedures, examinations and quantitative metrics described above than through requirements that could discourage risk-reducing hedging.

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<sup>231</sup> Options on U.S. Treasuries are not part of the government obligations permitted activity. As we note below, however, we believe they should be. See the discussion beginning on page A-75.

<sup>232</sup> Proposal at 68,875 (FRB 67).

<sup>233</sup> *Id.* (emphasis added).

Finally, implicit in the requirement for correlation as well as in the criticism of underhedging is the notion that an underlying position may be permissible, but the combination of the underlying position and the hedge calls into question the combined transaction. Since the acquisition of the hedged position itself will be required to be compliant with the Volcker Rule, we believe such a view would be inappropriate. This is also not consistent with safety and soundness; if a hedge reduces the risk of the hedged position, or otherwise assists in bringing the combined risk within risk limits, it should be permissible.

## E. Choice of Hedging Strategy

**Recommendation:** The Agencies should confirm that banking entities may choose to use any hedging strategy that meets the requirements of the risk-mitigating hedging permitted activity, and do not have to choose the “best hedge” along any specific dimension.<sup>234</sup>

In most instances, more than one hedging strategy may satisfy the requirements of the risk-mitigating hedging permitted activity. We believe that a trading unit should be free to use its discretion to choose among these valid hedging strategies regardless of motivation, without fear of *ex post* questioning of their motivation by the Agencies.

The Preamble’s discussion of hedging vehicles suggests that regulators may scrutinize the choice of hedges on a *post hoc* basis to see if the best correlated cost-effective hedge was used.<sup>235</sup> However, the Proposal does not clearly indicate criteria by which one hedge instrument or another must be chosen, nor should it do so.<sup>236</sup> We ask the Agencies to confirm that any permissible hedge instrument may be chosen, even if the purpose of choosing one rather than another is that the chosen hedge instrument is cheaper than its fair value and, as a result, its price could improve. Otherwise, uncertainty over how profitable hedges will be treated may lead banking entities to not use the most cost-effective hedges to avoid possible regulatory inquiry, which would make hedging less efficient and would raise costs for both the banking entities and their customers.

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<sup>234</sup> We believe this section is responsive to Questions 104, 107 and 110 in the Proposal.

<sup>235</sup> Proposal at 68,875 (FRB 66-67).

<sup>236</sup> See Proposal § \_\_.5(b)(2)(iii).

## F. Anticipatory Hedging

**Recommendation:** Permitted anticipatory hedging should be explicitly allowed and should not be limited to “slightly” before a risk is taken.<sup>237</sup>

The Preamble states that the hedging permitted activity “would be available in certain cases where the hedge is established slightly before the banking entity becomes exposed to the underlying risk if such anticipatory hedging activity: (i) is consistent with appropriate risk management practices; (ii) otherwise meets the terms of the hedging exemption; and (iii) does not involve the potential for speculative profit.”<sup>238</sup> The Preamble further provides as an illustrative example that “if a banking entity was contractually obligated, or otherwise highly likely, to become exposed to a particular risk and there was a sound risk management rationale for hedging that risk slightly in advance of actual exposure, the hedging transaction would generally be consistent” with the requirement that a covered financial position must hedge specific risks.<sup>239</sup> We agree that anticipatory hedging is a crucial part of risk management practices and, as such, should be allowed within the permitted activity.

Further, we believe that the Agencies’ apparent limitation of anticipatory hedging to “slightly” before a risk is taken is unnecessary and overly restrictive. Instead, we believe that a banking entity should be able to hedge any risk that the banking entity is “contractually obligated, or otherwise highly likely” to take, as in the words of the Preamble, regardless of how far in the future that risk is contemplated. Banking entities should be encouraged, not discouraged, from sound risk management policies that actively consider future risks and take positive steps to mitigate them. In addition, we believe that the requirement that an anticipatory hedge “does not involve the potential for speculative profit” should be removed, as there is always the possibility that the instrument will appreciate in value and lead to profit, which may be viewed *ex post* as a speculative position.<sup>240</sup>

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<sup>237</sup> We believe this section is responsive to Question 108 in the Proposal.

<sup>238</sup> Proposal at 68,875 (FRB 66); *see also* Proposal § \_\_.5(b)(2)(ii).

<sup>239</sup> Proposal at 68,875 (FRB 66).

<sup>240</sup> *See* Proposal at 68,875 (FRB 66).

## G. Continuing Review Requirements

**Recommendation:** The continuing review requirements should focus on the overall portfolio of a trading unit, rather than on individual hedges.<sup>241</sup>

The Proposal requires that a qualifying risk-mitigating hedge must be “subject to continuing review, monitoring and management by the covered banking entity that: (A) is consistent with the written hedging policies and procedures required under . . . this section; and (B) maintains a reasonable level of correlation, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and (C) mitigates any significant exposure arising out of the hedge after inception.”<sup>242</sup> The Proposal is not clear whether this review, monitoring and management must be done on the individual hedge level or across the overall portfolio of a trading unit.

As stated throughout this comment letter,<sup>243</sup> we believe that the Volcker Rule permitted activities should be viewed at an activity level, not at a transaction-by-transaction level. We believe that the review process listed above can be effectively applied at the management level above the one that placed the hedge trade. In addition, individual tagging and instrument-by-instrument analysis would be overly burdensome without significant benefit and would not accord with the Agencies’ explicit comments that portfolio hedging is permissible.<sup>244</sup>

## H. Coordinated Hedging

**Recommendation:** Coordinated hedging through and by affiliates should be eligible for the risk-mitigating hedging permitted activity.<sup>245</sup>

As discussed below,<sup>246</sup> we believe that activities engaged in by affiliates on a coordinated basis, whether or not linked through an interaffiliate transaction, should qualify

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<sup>241</sup> We believe this section is responsive to Questions 109 and 112 in the Proposal.

<sup>242</sup> Proposal § \_\_.5(b)(2)(v).

<sup>243</sup> See, e.g., the discussion beginning on page A-34.

<sup>244</sup> See Proposal at 68,875 (FRB 65).

<sup>245</sup> We believe this section is responsive to Questions 102 and 105 in the Proposal.

<sup>246</sup> See the discussion beginning on page A-90.



on a consolidated basis for a permitted activity. We believe this is particularly critical in the context of risk-mitigating hedging, as interaffiliate transactions are often used to shift risk throughout the organization to the entity best able to mitigate it. We discuss below the wide range of uses for interaffiliate transactions,<sup>247</sup> perhaps the most important of which is efficient risk management. For example, a bank may enter into a transaction with a customer but shift the risk to an affiliated broker-dealer through an interaffiliate swap so that the broker-dealer, with better access to appropriate hedging instruments, can hedge the risk in the market. In such a case, we believe that the entire set of transactions described—the swap from the bank to the broker-dealer, the broker-dealer’s side of the swap and the broker-dealer’s hedging activities in the market—should qualify as risk-mitigating hedging. This may occur, for example, in the context of structured products issuances, in which an affiliated broker-dealer may enter into a risk-shifting swap with the issuer of the structured note and then hedge the risk in the cash markets. Failing to allow for such enterprise-wide risk mitigation will increase the risks and make booking less efficient, without any corresponding benefit.

More generally, an individual business activity of a banking entity may span multiple entities. Risk limits and risk mitigation will not be appropriately calculated unless the business activity is viewed holistically. Particular metrics cannot be viewed merely on an entity-by-entity basis. This is especially the case in the context of “split hedges” where one legal entity holds a position and another holds the hedge.

## I. Cross-Level Documentation

**Recommendation:** Policies and procedures are sufficient to address hedging at a level of the organization other than where the risk resides; additional documentation should only be required if a hedge put on two levels above the level of the risk goes beyond the hedging covered by the policies and procedures.<sup>248</sup>

The Agencies have proposed that a trading unit that puts on a hedge position at a level of the organization different from where the risk resides must contemporaneously document the reasons for that trade.<sup>249</sup> We believe that this documentation requirement is meant to ensure that cross-level hedges truly hedge risks in the organization at the time they are initiated and are not subsequently justified as hedges by referencing some risk in the organization not contemplated at the time the “hedging” position was taken on. We believe, however, that the same purpose could be achieved, with significantly less burden on banking

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<sup>247</sup> See the discussion beginning on page A-90.

<sup>248</sup> We believe this section is responsive to Questions 109 and 114 in the Proposal.

<sup>249</sup> Proposal § \_\_.5(c).

entities, by requiring reasonably designed policies and procedures of a trading unit that control when and where a cross-level hedge can be used. The policies and procedures should require documentation of the purpose of the hedge to the extent that the banking entity needs to engage in new types of hedging transactions, such as in a particularly volatile market, and to the extent there are levels of the banking entity in between that at which the hedge was put on and the level of the risk that was trying to be hedged. In addition, reported quantitative metrics and risk limits will assist the Agencies in determining whether a hedge at a different level of the organization appropriately reduced risk, without the need for contemporaneous documentation as to its purpose.

## V. Government Obligations Permitted Activity

### A. Derivatives on Permitted Government Obligations

**Recommendation:** The permitted activity should include trading in derivatives on permitted government obligations.<sup>250</sup>

The government obligations permitted activity permits trading in (i) an obligation of the United States or U.S. agency; (ii) an obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; or (iii) an obligation of any State or any political subdivision.<sup>251</sup> The permitted activity, however, does not include trading in derivatives on these instruments. We believe that the permitted activity regarding government obligations should be expanded to include derivatives on those instruments.

Banking entities trade derivatives on government obligations as part of their activities in the underlying obligation. For example, a banking entity may trade Treasury futures as part of its Treasuries trading strategy with the trading units dealing in government bonds and derivatives as part of an integrated trading and hedging activity. Limiting the permitted activity to only the underlying cash instruments would significantly restrict the activity explicitly permitted by Congress, which is separate and distinct from the market making and hedging permitted activities. As a result, liquidity in the Treasury market, Agency securities market and other government obligations markets would significantly decrease, contrary to the intent of Congress and the public policy interest of the U.S. taxpayer in carving out this activity from the general statutory text of the Volcker Rule proprietary trading restrictions.

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<sup>250</sup> We believe this section is responsive to Question 121 in the Proposal.

<sup>251</sup> See Proposal § \_\_.6(a)(1).

## B. State and Municipal Agency Obligations

**Recommendation:** The permitted activity should include trading in state and municipal agency and authority obligations.<sup>252</sup>

We believe that the government obligations permitted activity should be expanded beyond state and municipal government bonds to include state and municipal agency and authority obligations.<sup>253</sup> In particular, we believe that the Agencies should include in the permitted activity all instruments that meet the definition of “municipal securities” in Section \_\_.3(c)(9) of the Proposal, which section refers to Section 3(a)(29) of the Exchange Act.<sup>254</sup> State and municipal obligations fund important local activities such as hospitals, nursing homes, sewage treatment and industrial development facilities. By excluding state and municipal agency and authority obligations, the permitted activity would cover only roughly 60% of the municipal securities currently outstanding. While we understand that the statutory Volcker Rule supersedes conflicting law,<sup>255</sup> we note that the National Bank Act and OCC Part 1 make no distinctions between the ability of national banks to underwrite, trade and deal in municipal agency or authority securities, even though they are not able to trade or deal in corporate securities, and the Board provided a discretionary exception in Regulation W for municipal securities to further the public policy goals of promoting liquidity in the municipal securities markets.<sup>256</sup> In addition, for the same reasons mentioned above with respect to U.S. Treasuries,<sup>257</sup> we believe that derivatives on such municipal securities should also fall within the permitted activity.

Municipal securities markets rely on banking entities to create liquidity in what would otherwise be a fragmented, less liquid market. The result of adopting the Proposal, as

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<sup>252</sup> We believe this section is responsive to Questions 120, 121, 123 and 142 in the Proposal.

<sup>253</sup> The Agencies note that the Proposal “does not extend the government obligations exemption to transactions in obligations of an *agency* of any State or political subdivision thereof.” Proposal at 68,878 n. 165 (FRB 72 n. 165) (emphasis in original).

<sup>254</sup> Exchange Act Section 3(a)(29) states that “the term ‘municipal securities’ means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in section 103(c)(2) of Title 26) the interest on which is excludable from gross income under section 103(a)(1) of Title 26 if, by reason of the application of paragraph (4) or (6) of section 103(c) of Title 26 (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security.” 15 U.S.C. § 78c(a)(29).

<sup>255</sup> Bank Holding Company Act § 13(g)(1) (as added by Dodd-Frank § 619).

<sup>256</sup> See generally Letter from Citigroup Global Markets Inc. to the Agencies (January 27, 2012).

<sup>257</sup> See the discussion beginning on page A-75.

with other less liquid instruments, would be a dramatic and adverse effect on the liquidity of the municipal market, a wider bid-ask spread and less access for municipal issuers to low-cost financing for essential governmental projects. As is the case with other covered financial positions, any negative impact on liquidity will lower the demand for, and therefore the price of, issuances. In the municipal bond market in particular, investors frequently sell current holdings to raise the capital needed to invest in a new issue of bonds. Thus, a permitted activity is required to avoid significantly reduced liquidity in the secondary market, making it harder for the hospitals and other tax-exempt finance-supported activities to raise funds due to decreased initial demand for a position that is difficult to exit.

We believe that an exclusion for state and municipal agency and authority obligations is consistent with congressional intent. We see no reason to exclude these obligations while the obligations of federal agencies, and of the states and municipalities themselves, are included in the permitted activity. Accordingly, we recommend interpreting Section \_\_.6(a)(iii) to include all municipal securities as defined in Section \_\_.3(c)(9). Alternatively, we believe that a permitted activity for trading in state and municipal agency and authority obligations would meet the Agencies' high hurdle, in Section (d)(1)(J) of the statutory Volcker Rule, to "determine, by rule, [that the new permitted activity] would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."<sup>258</sup>

### C. Foreign Sovereign Debt

**Recommendation:** The permitted activity should include trading in foreign sovereign debt of countries to the extent otherwise permitted by law.<sup>259</sup>

The Agencies ask whether the government obligations permitted activity should be expanded to include the obligations of foreign governments and international and multinational development banks and, if so, what obligations should be exempt and how such an exemption would promote and protect the safety and soundness of banking entities and the financial stability of the United States.<sup>260</sup> We believe that the Agencies should make a determination that the permitted activity allows trading in sovereign debt of any foreign jurisdiction, as well as derivatives on those instruments, to the extent otherwise permitted by law. We further believe that all securities issued by international and multinational development banks should be incorporated within the permitted activity.

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<sup>258</sup> Bank Holding Company Act § 13(d)(1)(J) (as added by Dodd-Frank § 619).

<sup>259</sup> We believe this section is responsive to Questions 122, 123 and 142 in the Proposal.

<sup>260</sup> See Question 122.

Banking entities operate in an increasingly global economy, where the financial stability of many countries is interlinked with that of the United States and the banking entities themselves. The impact of developments in the EU debt crisis on U.S. market conditions demonstrates these links day by day. In addition, since foreign sovereign debt is used by banking entities and their customers as collateral and for liquidity and asset-liability management purposes, decreased liquidity in these markets will harm the safety and soundness of U.S. financial markets.<sup>261</sup> As a result, the same considerations that led Congress to explicitly permit proprietary trading for U.S. sovereign debt should be applied to the Agencies' decision to permit proprietary trading in foreign sovereign debt.

In addition, giving preferential treatment to U.S. sovereign debt while applying the Volcker Rule internationally may encourage other countries to respond with similarly nationalist measures. Regulators and market participants from foreign jurisdictions have already started to weigh in on the negative affects they will face if the government obligations permitted activity is not expanded. Canadian regulators have argued that the failure to include foreign government securities, including Canadian securities, “would undermine the liquidity of government debt markets outside of the US and could significantly impede the ability of foreign banks to efficiently manage their liquidity and funding requirements at an enterprise-wide level.”<sup>262</sup> The Japanese Bankers Association has pointed out the potential “disequilibrium and unfairness” that could cause “global financial turbulence, and the destruction of the supply-demand balance [that in turn] could result in an unstable market environment around the world.”<sup>263</sup> EU Internal Markets Commissioner Michel Barnier has stated that “[t]he absence of an exemption for non-US bonds would have a negative impact on the liquidity of non-US sovereign markets.”<sup>264</sup>

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<sup>261</sup> Oliver Wyman 2012 Study at 35 (“Reduced liquidity in the foreign sovereign debt markets will naturally have similar knock-on effects to those described for the US corporate bond market – all else equal, the markets would see increased transactions costs for investors and other counterparties, one-off market-to-market losses as liquidity is reduced, and likely future increased borrowing costs for issuers (in this case, governments).”).

<sup>262</sup> Letter from Julie Dickson, Office of the Superintendent of Financial Institutions Canada, to the Agencies (Dec. 28, 2011). *See also* Letter from Gadi Mayman, Ontario Financing Authority, to the Agencies (Jan. 31, 2012) (“Unimpeded access to capital markets is critical to Ontario as a government borrower because of its reliance on both domestic and U.S capital markets' participants as a source of funding and liquidity.”); Letter from Luc Monty, Ministry of Finance of Quebec, to the Agencies (Feb. 9, 2012) (“[W]e are concerned by what we see as an advantage given to the securities of US governmental and government-sponsored entities over securities of similar entities in Canada with respect to access to capital markets. This may, per se, constitute a violation of the North America Free Trade Agreement.”).

<sup>263</sup> Letter from Japanese Bankers Association to the Agencies (Jan. 13, 2012).

<sup>264</sup> Letter from Michel Barnier, European Commissioner for Internal Market and Services, to the Agencies (Feb. 8, 2012). Commissioner Barnier further observed that it is “not clear . . . why this exemption should be limited to trade in US government bonds,” given that “[a]ll government bonds have similar features and functionalities.” *Id.*

In addition, many of our members operate in foreign jurisdictions where local branches or agencies of multinational banking entities are required, by local law, to hold or transact in local sovereign debt. Some are primary dealers that may be required to take down a specified percentage of any government offering. If foreign sovereign debt is not included in the permitted activity, such banking entities will be faced with an irreconcilable conflict in cases where there is insufficient short-term customer demand for the securities that the banking entity is required to take down. If foreign sovereign debt is not exempted through this permitted activity, the Agencies must ensure that the market making and underwriting permitted activities allow banking entities to engage in these activities. More generally, for reasons of comity, we believe that the Volcker Rule should include an exemption for activities of a foreign banking entity in sovereign debt or other instruments, regardless of the domicile of its parent banking organization, that are encouraged or required by the law of its host jurisdiction.

## VI. On Behalf of Customers Permitted Activity

### A. Narrowness of On Behalf of Customers Permitted Activity

**Recommendation:** The permitted activity defines “on behalf of customers” too narrowly and should include, for example, transactions by a banking entity as principal to facilitate a customer need where the banking entity substantially hedges the resulting principal position.<sup>265</sup>

The statutory Volcker Rule permits the “purchase, sale, acquisition, or disposition of securities and other instruments . . . on behalf of customers.”<sup>266</sup> The Proposal narrowly interprets this provision by limiting qualifying transactions to (i) trading as a fiduciary for the account of a customer; (ii) acting as a riskless principal by purchasing or selling a covered financial position for the banking entity’s own account contemporaneously with a sale or purchase from a customer; or (iii) acting for an insurance separate account.<sup>267</sup> We agree that these transactions are “on behalf of customers” but believe that the Proposal’s definition is overly narrow and does not adequately reflect congressional intent to permit all transactions “on behalf of customers.”

We believe that the permitted activity should be expanded to better reflect how banking entities engage in transactions on behalf of customers. For example, the Agencies could include within the permitted activity transactions done by a banking entity to respond to a customer need where the banking entity is acting as principal to accommodate the customer and the risks of this transaction are substantially hedged by the banking entity. The Agencies can examine banking entities’ activities and will be informed, through the risk-related quantitative metrics, of situations in which the risks of the customer business are not being substantially hedged.

We believe that if the permitted activity is adopted as proposed, customers would be unable to engage in many transactions they currently use for legitimate purposes, including capital formation. Currently, banking entities act as principal to address customer needs in a wide variety of circumstances in which the banking entity does not intend to carry principal risks. In these cases, the banking entity shoulders the risk in a transaction, facilitating a customer transaction that cannot be effectively done as agent, which it substantially hedges promptly, while providing the customer the economic return on the transaction in a simple, cost-effective manner. In many cases, these transactions are similar in

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<sup>265</sup> We believe this section is responsive to Questions 125 and 131 in the Proposal.

<sup>266</sup> Bank Holding Company Act § 13(d)(1)(D) (as added by Dodd-Frank § 619).

<sup>267</sup> Proposal § \_\_.6(b)(2).



purpose to riskless principal transactions but do not clearly fit within the narrow proposed riskless principal requirement.<sup>268</sup>

While these transactions may arguably fall within the market making-related permitted activity, rightly construed, the uncertainty and cost of that determination may discourage banking entities from offering principal accommodations to customer needs. For example, we would appreciate the Agencies clarifying that banking entities can take on long positions as a result of buy-ins from a securities lender in order to protect existing customer short positions from forced close-outs. Similarly, it is unclear whether banking entities would be able to cover purchases to satisfy Rule 204 close-out obligations or to cure Rule 15c3-3 segregation possession and control obligations.

As stated below,<sup>269</sup> we believe that transactions entered into for funding purposes should be excluded from the trading account. If such an exclusion is not provided, we believe it is critical that transactions entered into to provide customer funding be considered “on behalf of customers.”

Finally, we believe this permitted activity should include financial instruments entered into by banking entities to meet a customized client need, such as creating structured products, holding specific positions in inventory that a customer intends to buy or to put into a fund, as long as the banking entity remains substantially hedged. If the “on behalf of customers” and market making-related permitted activities are not expanded to allow these structured and bespoke transactions,<sup>270</sup> banking entities will not be able to serve the vital role of providing customers with financial instruments closely tailored to their capital-raising, hedging and other critical needs. Since these transactions may be capital-intensive, it is unclear that any other market participants would be able to provide the service.

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<sup>268</sup> In addition, we note that the three sources that the Agencies point to regarding guidance on “riskless principal transaction,” the Board’s Regulation Y, the SEC’s Rule 3a5-1 under the Exchange Act and OCC relevant interpretive letters, do not provide identical definitions of riskless principal transactions.

<sup>269</sup> See the discussion beginning on page A-83 and on page A-101.

<sup>270</sup> See the discussion beginning on page A-37.

## B. Clearing-Related and Prime Brokerage Activities

**Recommendation:** If clearing-related activities are not excluded from the trading account, customer clearing, as well as prime brokerage activities, should be explicitly included in the “on behalf of customers” permitted activity.<sup>271</sup>

We believe, for the reasons stated below,<sup>272</sup> that the clearing-related activities of banking entities, including where banking entities are acting as prime brokers, should be explicitly excluded from the trading account. To the extent the Agencies choose not to do so, however, we believe that the Agencies should explicitly include activities related to clearing and prime brokering of customer covered financial positions in the “on behalf of customers” permitted activity. These activities should include, but not be limited to, securities clearing and coverage of fails, clearing swaps for customers in both the “principal” and “agency” clearinghouse models; margin collection, custody and movement; positions taken on as a result of crossing transactions required by clearinghouses to verify submitted instrument prices; and default management including porting of positions, auctions and guaranty fund contributions. For example, a prime broker should not be required to close out a client’s short position if the prime broker accepts a buy-in from the lender of the security; rather, the prime broker should be permitted to retain that economic exposure on behalf of the short client.

In the swaps context, since a transaction can only be cleared by submitting both sides to a clearinghouse, this requires not only that the cleared customer leg of the transaction be treated as an “on behalf of customers” permitted activity, but also, if the clearing member or its affiliate is the counterparty to the transaction, that the house leg of the transaction be treated as such. We also believe that any entity that uses the banking entity as its clearing member to access the clearinghouse, including affiliates of the banking entity and other dealers, should be treated as clearing “customers” for this purpose.

We believe these activities clearly fall within the “on behalf of customers” permitted activity. In many cases, customers will be legally required to clear transactions. For example, Title VII and its proposed implementing regulations will require mutual funds to clear the standardized swaps they enter into with banking entities.<sup>273</sup> Even where clearing is not required, however, it benefits customers in reducing the counterparty credit risk they face to the clearinghouse. Finally, as stated below, we believe that no policy goal is furthered by restricting clearing-related activities, as these activities are not used by banking entities for speculative proprietary trading purposes.

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<sup>271</sup> We believe this section is responsive to Question 131 in the Proposal.

<sup>272</sup> See the discussion beginning on page A-87.

<sup>273</sup> See the discussion beginning on page A-87.

## VII. Excluded Transactions

### A. Repurchase Agreements

**Recommendation:** The exclusion from trading account for repurchase agreements is appropriate, but should be expanded to include transactions related to such agreements and should explicitly clarify that all types of repurchase transactions qualify for the exclusion.<sup>274</sup>

The definition of trading account excludes an account “to the extent it is used to acquire or take a position in covered financial positions that arise under a repurchase or reverse repurchase agreement (“**repo**”) pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty.”<sup>275</sup> We believe an exclusion for repo transactions is appropriate and that the definition used in the Proposal captures typical transactions. We believe, however, that the repo exclusion should explicitly incorporate transactions entered into by the banking entity in support of the repo transaction, including transactions through which covered financial positions are purchased to meet delivery obligations under repo agreements. Otherwise, banking entities might be precluded from meeting delivery obligations where the market for borrowing an instrument is less liquid but cash market purchases are possible.

We believe that the Proposal’s exclusion is meant to incorporate all forms of repo currently engaged in by banking entities. However, in light of the Agencies’ specific questions on the subject and for purposes of clarity, we believe the Agencies should be more explicit. For example, while we believe that the current repo exclusion incorporates open-ended repo contracts in addition to term repo (including term repo that uses a collateral schedule), overnight repo and repo to maturity, we believe the Agencies should explicitly incorporate all of these types of repo transactions in the exclusion. We also believe that the Agencies should explicitly state that the repo exclusion applies regardless of the operational style of repo transaction, including tri-party, deliverable and hold in custody repo. Finally, we believe that the “same counterparty” part of the exclusion should not be read to mean that repo entered into with an agent on behalf of an undisclosed principal should not qualify for the exclusion even if, as may occur, the agent reallocates the repo positions over time. These additional clarifications will help banking entities enter into repo transactions without fear of accidentally falling within the “trading account” definition.

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<sup>274</sup> We believe this section is responsive to Questions 30 and 32 in the Proposal.

<sup>275</sup> Proposal § \_\_.3(b)(2)(iii)(A).

## B. Transactions Not Based on Expected or Anticipated Movements in Asset Prices

**Recommendation:** Transactions “not based on expected or anticipated movements in asset prices,” such as fully collateralized swap transactions that serve funding purposes, should be exempted from the definition of trading account.<sup>276</sup>

The Agencies exempt repurchase transactions from the trading account because these “positions . . . are not based on expected or anticipated movements in asset prices.”<sup>277</sup> We agree with this logic and believe the Agencies should adopt it as a general rule, exempting all transactions that are not based on expected or anticipated movements in asset prices. These types of asset purchases and sales do not appear to be the type of transaction intended to be covered by the statutory definition of trading account.<sup>278</sup> For example, we believe that fully collateralized swap transactions, while legally distinct from lending arrangements, serve as funding transactions and are economically similar to repo and therefore should be exempted from the definition of trading account. Banking entities may provide or receive financing through fully collateralized total return swaps, which have predetermined payment obligations. This exception should also encompass transactions related to providing such funding such as asset swaps and foreign exchange swaps. Without an appropriate exception from the trading account definition, these common forms of funding transactions might appear to be prohibited proprietary trading, regardless of their economic similarity to repo transactions.

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<sup>276</sup> We believe this section is responsive to Questions 20 and 43 in the Proposal.

<sup>277</sup> Proposal at 68,862 (FRB 37).

<sup>278</sup> As discussed below, we believe similar logic applies to exempting foreign exchange swaps and forwards from the definition of trading account. See the discussion beginning on page A-101.

## C. Securities Lending Transactions

**Recommendation:** The exclusion from trading account for securities lending transactions is appropriate, but should be expanded to include transactions related to securities lending operations, such as transactions where a security is purchased to cover a short position or purchased or created in order to lend.<sup>279</sup>

The definition of trading account excludes an account “to the extent [it] is used to acquire or take a position in covered financial positions that arise under a transaction in which the covered banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties.”<sup>280</sup> We believe an exclusion for securities lending transactions is appropriate and that the definition used in the Proposal captures typical securities lending transactions. As with the exclusion for repurchase and reverse repurchase agreements, however, we believe that the securities lending exclusion should include transactions entered into by the banking entity in support of the securities lending transactions, including transactions where a security is purchased to cover a short position or purchased or, in the case of ETFs, created in order to lend.

## D. Debts Previously Contracted

**Recommendation:** The Agencies should exclude activities related to assets received in satisfaction of debts previously contracted from the definition of “trading account.”<sup>281</sup>

The Proposal allows banking entities to acquire and retain an ownership interest in, or act as a sponsor to, a “covered fund” if done in the ordinary course of collecting a debt previously contracted.<sup>282</sup> No analogous exception exists from the Proposal’s

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<sup>279</sup> We believe this paragraph is responsive to Questions 30 and 32 in the Proposal.

<sup>280</sup> Proposal § \_\_.3(b)(2)(iii)(B).

<sup>281</sup> We believe this section is responsive to Questions 20 and 43 in the Proposal.

<sup>282</sup> See Proposal § \_\_.14(b)(1) (stating that the prohibition on having certain relationships with a covered fund “does not apply to the acquisition or retention by a covered banking entity of any ownership interest in, or acting as sponsor to, a covered fund . . . if such ownership interest is acquired or retained by a covered banking entity . . . [i]n the ordinary course of collecting a debt previously contracted in good faith,” provided that the banking entity must divest the ownership interest within the time period provided for by the applicable Agency). The Agencies note that “[a]llowing banking entities to rely on these authorities for (...continued)

proprietary trading restrictions. We believe that the Agencies should create a similar exception from the definition of “trading account” for transactions related to financial instruments received in partial or full satisfaction of debts previously contracted—whether through foreclosure, restructuring, or any of the other circumstances permitted for a bank or bank holding company to receive them in satisfaction of debts—which would make explicit that such are part of the exclusion from the trading account for loans. Such an explicit exclusion would encourage banking entities to act as secured lenders, would allow banking entities to dispose of assets foreclosed upon in a prudent manner and avoid proprietary trading concerns.

An exclusion for transactions related to debts previously contracted would promote lending by banking entities, a goal approved by the Agencies through the exclusion of loans from the definition of “covered financial position.”<sup>283</sup> For example, banking entities that take collateral for loans from customers will not provide these loans if the Volcker Rule makes it difficult for them to foreclose on collateral. Similarly, banking entities may not engage in margin loans, including in the prime brokerage context, if it is problematic to take possession and dispose of assets in case of a customer default.

A banking entity that takes possession of assets it forecloses upon should be able to dispose of those assets in a prudent, value-maximizing manner. In foreclosing on collateral, a banking entity may acquire very large positions that are not consistent with its long-term risk management strategy. However, the Agencies should also not require banking entities to dispose of these assets as quickly as possible as part of any debts previously contracted exclusion. The large size of these transactions may make it difficult for banking entities to dispose of them rapidly at anything but low, fire sale prices.<sup>284</sup> Instead, banking entities should be able to sell these positions in a prudent and value-maximizing manner. Any aspect of the Proposal that limits the value that the banking entity can obtain for foreclosed-upon collateral will raise the price for customers of obtaining loans from banking entities in the first place.

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(continued...)

acquiring or retaining an ownership interest in or acting as sponsor to a covered fund will enable banking entities to manage their risks and structure their businesses in a manner consistent with their chosen corporate form and . . . would promote and protect the safety and soundness of a banking entity, and would also promote and protect the financial stability of the United States.” Proposal at 68,914 (FRB 152).

<sup>283</sup> See Proposal § \_\_.3(b)(3)(ii)(A).

<sup>284</sup> See the discussion on block positioners in the market making context, beginning on page A-40. Similar concerns also apply to a clearinghouse member’s disposal of positions taken on as part of the clearinghouse’s default management process. Such activity should be part of the debt previously contracted exclusion, but also should be covered by an exclusion for clearing-related activity by banking entities, discussed below. See the discussion beginning on page A-87.

## E. Clearing-Related Activities

**Recommendation:** The Agencies should exclude a banking entity's clearing-related activities from the "trading account" definition.<sup>285</sup>

Many banking entities are members of central clearinghouses for covered financial positions. In this capacity, they clear transactions for themselves, for affiliates and for unaffiliated clearing customers. Other banking entities serve as customers of these clearinghouse members in order to clear their trades in covered financial products. Congress has clearly indicated its conviction that central clearing is risk-reducing and beneficial for the financial system through the key role Congress has established for central clearing in the new regulatory regime for swaps and security-based swaps.<sup>286</sup>

While clearing-related activities, either as a clearing member or a customer of a clearing member, do not involve proprietary trading intent and are clearly outside of Congress' and the Agencies' intended Volcker Rule scope, there is no explicit exclusion for these activities. As a result, we believe that the Agencies should explicitly exclude clearing-related activities from the definition of "trading account."<sup>287</sup> While we believe that this activity would qualify for the "on behalf of customers" permitted activity, we believe that the narrowness of that permitted activity and the additional burden on banking entities of confirming that clearing activities fall within the permitted activity demonstrate the need for an explicit exclusion from the definition of "trading account."<sup>288</sup>

An explicit exclusion for clearing-related activities would clarify the Volcker Rule treatment of transactions through which a covered financial position is cleared. In one clearinghouse model, generally known as the "agency model," clearing members act as agents in a transaction between their customer and the clearinghouse. While such a transaction is clearly outside the intended scope of the "trading account" definition, several aspects of the

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<sup>285</sup> We believe this section is responsive to Questions 20 and 43 in the Proposal.

<sup>286</sup> See 7 U.S.C. § 2(h) (as amended by Dodd-Frank § 723); 15 U.S.C. § 78c-3 (as added by Dodd-Frank § 763); see also 156 Cong. Rec. S5906 (daily ed. July 15, 2010) (Title VII "will require a significant portion of derivatives trades to be cleared through a centralized clearinghouse and traded on an exchange, and it will also increase reporting and capital and margin requirements on significant players in the market. The new regulatory framework will help improve transparency and disclosure within the derivatives market for the benefit of all investors.").

<sup>287</sup> The definition of "trading account" does have an exclusion for activities of a clearinghouse, see Proposal § \_\_.3(b)(2)(iii)(D), but not for clearing-related activities of banking entities that serve as clearing members or have their transactions cleared.

<sup>288</sup> As a result, if the Agencies do not provide an exclusion from the trading account definition, we ask that the Agencies should clarify that these are "riskless principal" transactions within the scope of the "on behalf of customers" permitted activity.

relationship make the treatment unclear. For example, the SEC has suggested that it will require entities that collect margin from customers for cleared swaps to register as broker-dealers. As such, the collection of margin from clearing customers, required by the clearinghouse as part of its risk-mitigating activity, could fall within the “status test” of the trading account definition. The other primary clearinghouse model, generally known as the “principal model,” raises even greater concerns of being inadvertently captured by the definition of “trading account,” as a trade in a covered financial position is cleared through the creation of one principal transaction between the customer and the clearing member and another principal transaction between the clearing member and the clearinghouse. Without an explicit exclusion, these principal transactions could fall within the definition of “trading account.”

An explicit exclusion for clearing member activity would also clarify the treatment of the transactions that a clearing member engages in as part of the default management process. Clearinghouses initially reduce the risk of default through the collection of initial and variation margin. If a default does occur or seems likely to occur, however, the clearinghouse reduces the impact of the default and the possibility of defaults by other entities through a complex default management process, several aspects of which involve non-defaulting clearing members. For example, a clearing member may accept the positions of a defaulting clearing member through a process known as “porting,” which allows the customers of the defaulting clearing member to keep their existing transactions without needing to unwind them with the defaulting clearing member and reestablish them with another. As another example, in becoming a member of a clearinghouse, a clearing member assumes the risk that contributions made to a “guaranty fund” will be lost and, if the guaranty fund is exhausted, that they will be assessed an additional amount to ensure the stability of the clearinghouse.

Clearing members engage in a number of other activities that are critical to clearinghouse management but may, inadvertently, fall within the definition of “trading account.” For example, clearing members provide daily prices for cleared instruments to the clearinghouse so that the clearinghouse can, among other things, calculate margin requirements. To ensure that clearing members are providing prices that truly reflect their valuation of the instrument, the clearinghouse will from time to time require a clearing member to execute a transaction for its own account at that price. Holding such a position for the long term may not be consistent with the clearing member’s portfolio or risk limits. Without a clear exclusion for this activity from the definition of “trading account,” the initial crossing transaction and subsequent sale might fall within the “trading account” definition.

We believe that no policy goal is furthered by including clearing-related activities in the definition of trading account. These activities are not used by banking entities to engage in proprietary trading. Congress has concluded that they reduce, rather than



increase, the risk of the financial system. In many cases, banking entities are required by law to clear their transactions in covered financial positions.<sup>289</sup> In addition, banking entities should be encouraged, rather than discouraged, from acting as clearing members so that non-members can access clearinghouses through them. Due to the large capital and significant operational requirements that clearing members must meet to ensure that they can help mutualize risk and absorb it in the case of default of another clearing member, most members of these clearinghouses are banking entities. It is unclear that any other type of entity would have the capital and operational expertise to serve in this capacity. For all these reasons, we believe that the Agencies should explicitly exclude “clearing-related activities” from the trading account definition.

## F. Asset Liability Management

**Recommendation:** The exclusion from trading account for certain “liquidity management” activities should be expanded to include all positions used in liquidity and other asset-liability management activities.<sup>290</sup>

We agree with other commenters, such as The Clearing House,<sup>291</sup> that the Proposal may significantly inhibit the ability of banking entities to engage in *bona fide* asset-liability management activities that are essential to the safe and sound management of the risks arising from the core business of banking. We refer you to their letter for a description of this critical function and the related issues that arise under the Proposal.

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<sup>289</sup> See 7 U.S.C. § 2(h) (as amended by Dodd-Frank § 723); 15 U.S.C. § 78c-3 (as added by Dodd-Frank § 763).

<sup>290</sup> We believe this section is responsive to Questions 33, 34, 40 and 41 in the Proposal.

<sup>291</sup> See Letter from The Clearing House to the Agencies (Feb. 13, 2012).

## G. Interaffiliate Transactions

**Recommendation:** The Agencies should view interaffiliate transactions as part of a coordinated activity for purposes of determining whether a banking entity falls within a permitted activity rather than as separate transactions to which separate “trading account” analyses would apply.<sup>292</sup>

The Proposal is silent on the treatment of interaffiliate transactions. We believe that trading activities by affiliated banking entities linked through use of interaffiliate transactions should be viewed as coordinated transactions for the purpose of complying with permitted activities, and that the interaffiliate transaction itself should be excluded from the “trading account” analysis.

Banking entities often engage in interaffiliate transactions to shift risk throughout the organization to the entity best able to mitigate it. While interaffiliate transactions may lead to a gain or loss in the account of a particular banking entity when viewed in isolation, they do not, by definition, lead to gains or losses in the account of the banking entity family. As a result, interaffiliate transactions generally do not pose a risk to the banking entity or the financial system; indeed, their very purpose is to manage and reduce risk. Nor do they give rise to conflicts of interest, since the risk-mitigating interests of the affiliates are aligned. We therefore believe that interaffiliate transactions conducted to facilitate a permitted risk-mitigating hedging activity should qualify on a consolidated basis for that permitted activity.

For example, a given banking entity may write a fund-linked instrument for a customer, but shift the accompanying risk exposure to an affiliated broker-dealer through an interaffiliate swap so that the broker-dealer, which may have better access to appropriate hedging instruments, can hedge the risk in the market. In such a case, we believe that the entire set of transactions described—the swap between the banking entity and the broker-dealer, the broker-dealer’s side of the swap and the broker-dealer’s hedging activities in the market—should qualify as a permissible risk-mitigating hedging activity. Failing to allow for such ordinary course risk mitigation practices would impose a needless impediment on the ability of banking entities to manage customer-driven risk, without any discernible corresponding benefit.

Affiliates frequently engage in coordinated activities linked through interaffiliate transactions, including interaffiliate swaps and securities transfers. As we have

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<sup>292</sup> We believe this section is responsive to Questions 20 and 43 in the Proposal.

explained at greater length in the swap dealer context,<sup>293</sup> interaffiliate transactions allow banking entities to transfer risk to affiliates best able to manage particular risks, reduce market risk through matching offsetting positions and limit operational risk by reducing the number of payments, deliveries and collateral movements. Interaffiliate transactions also enable the enterprise to use a single entity to face non-affiliated counterparties, which allows the banking entity to efficiently apply enterprise-wide risk management processes and increase netting benefits for exposure, capital and collateral. In addition, interaffiliate transactions benefit clients who wish to transact with an entity other than the bank's main booking entity that is located in a particular jurisdiction or country, speaks the same language or with whom they customarily deal.

We further believe that interaffiliate transactions reveal the inherent limitations of the trading account approach that is focused on particular transactions construed within a particular account. We believe that the Proposal should exclude interaffiliate transactions from the trading account analysis, and instead should recognize that interaffiliate transactions are part of a larger activity across entities.<sup>294</sup> Viewing interaffiliate transactions as between separate banking entities, rather than viewing the affiliates as part of an integrated whole, is inconsistent with the fact that entities are allowed to create enterprise-wide risk management systems to comply with the requirements of Appendix C of the Proposal.<sup>295</sup> It is also inconsistent with the definition of "trading unit," since members of the same trading unit may belong to, and book transactions in, different legal entities. Applying the trading account analysis to interaffiliate transactions will also produce results that do not reflect the economic reality of the underlying activity.

We believe that interaffiliate transactions should be viewed as part of a coordinated activity for purposes of determining whether a banking entity falls within each permitted activity, including underwriting, market making and hedging. For example, if a market maker shifts positions that must be held as inventory to an affiliate that is better able to manage the risk, we believe that both the market maker and its affiliate should be viewed as engaging in market making-related activities under that permitted activity. Fitting the interaffiliate swap into the market making-related permitted activity may be difficult; for example, one of the affiliates entering into the swap may not "hold itself out" as a willing swap counterparty. We do not believe that the transactions between the market maker and the

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<sup>293</sup> Joint Trade Associations Letter on Treatment of Inter-Affiliate Transactions under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Sept. 8, 2011).

<sup>294</sup> The Agencies can use their anti-evasion powers to assure that interaffiliate transactions are not used to mask prohibited proprietary trading. *See* Bank Holding Company Act § 13(e)(2) (as added by Dodd-Frank § 619).

<sup>295</sup> The Agencies note that Appendix C "permits a banking entity to establish a compliance program on an enterprise-wide basis to satisfy the requirements of § \_\_.20 of the proposed rule and the appendix, which program could cover the banking entity and all of its affiliates and subsidiaries collectively." Proposal at 68,919 (FRB 162).

affiliate should be analyzed separately and potentially prohibited if no permitted activity applies. Similarly, as discussed previously,<sup>296</sup> integrated hedging through interaffiliate transactions should be viewed for purposes of the risk-mitigating hedging permitted activity as a whole rather than as separate transactions. Moreover, it is essential that interaffiliate trades need not be viewed separately from broader cross-affiliate activity for purposes of calculating any relevant metric that may be useful under Appendix A.

If the Agencies are concerned that interaffiliate transactions might be used to mask impermissible proprietary trading, we strongly believe this does not comport with the practical realities underlying interaffiliate trades. Moreover, information produced under the metrics and the transparency from examinations should be able to illuminate any such evasive behavior.

As described above,<sup>297</sup> if the Agencies do not exclude interaffiliate transactions, the Agencies must ensure that the market making-related and other permitted activities allow for such transactions.

## H. Securitization

**Observation:** The Proposal impermissibly restricts the statutory exemption for loan securitizations.

We agree with other commenters that the Proposal impermissibly restricts the statutory exemption for loan securitizations. We refer you to the letter from SIFMA regarding the provisions of the Proposal that impact securitizations and insurance-linked securities for a description of securitization and related issues arising from its treatment under the Proposal.<sup>298</sup>

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<sup>296</sup> See the discussion beginning on page A-72.

<sup>297</sup> See the discussion beginning on page A-72.

<sup>298</sup> See letter from SIFMA to the Agencies regarding securitization (Feb. 13, 2012).

## VIII. Conflicts of Interest

### A. Disclosure

**Recommendation:** The Agencies should confirm that “clear, timely and effective disclosure” can take the form of either periodic or specific disclosures regarding transactions.<sup>299</sup>

The Proposal recognizes that one way a banking entity can effectively negate or mitigate potential conflicts of interest is through disclosure.<sup>300</sup> The Proposal, however, focuses only on transaction-specific disclosures that are “specific to the individual, class or type of transaction or activity.”<sup>301</sup> Although these types of disclosures are likely useful and adequate in the context of certain transactions (such as Complex Structured Finance Transactions (“CSFTs”)),<sup>302</sup> they are impractical in the context of ordinary course transactions executed as part of a typical trading relationships. For example, a client who seeks the services of a market maker should recognize that the market maker (or other trading units within the same banking entity) likely will be engaged in a variety of hedging activities and trading with other clients and dealers that also may result in the market maker taking conflicting positions. This and similar conflicts are inherent in market making and more generally in each banking entity’s daily business. Requiring trade-by-trade disclosures of such conflicts would be extremely burdensome to administer and unnecessary because clients understand the nature of a market maker’s role and would not benefit from transaction-by-transaction reminders of these types of conflicts.

In these situations, we believe that disclosures would be more “clear, timely and effective” if provided to the client at certain predetermined times (for example, at the inception of the trading relationship and annually thereafter). These disclosures would identify for the client the types of potential conflicts that are likely to be presented by ordinary course transactions on a regular basis, at a time when the client has adequate opportunity to consider them and make an informed decision about entering into a trading relationship and/or have a dialogue with the banking entity to better understand the nature of the conflict and how that banking entity addresses those conflicts in the normal course of business. In the absence of this style of general disclosures, there is a real risk that the transaction-by-transaction

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<sup>299</sup> We believe this section is responsive to Questions 190, 199, 202, and 206 in the Proposal.

<sup>300</sup> Proposal at 68,893 (FRB 106).

<sup>301</sup> Proposal § \_\_.8(b)(1).

<sup>302</sup> Complex Structured Financial Transactions, as defined in the multiple-agency statement of 2007. *See* Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities (Jan. 11, 2007).

disclosure will become formulaic and rote – reducing its effectiveness.<sup>303</sup> This periodic disclosure would describe the nature of the conflicts that may arise in various types of ordinary course transactions across various asset classes and would be customized to any unique aspects of the organization, business mix and model of the banking entity supplying the disclosures.

Accordingly, the Proposal should provide certainty for all market participants by confirming that trading relationship-level disclosures can mitigate effectively the types of potential conflicts described above, and confirming that trades pursuant to such disclosures would not be considered prohibited transactions. The statutory text of the Volcker Rule requires only that the transaction not “involve or result in a material conflict of interest . . . between the banking entity and its clients, customers, or counterparties.”<sup>304</sup> It does not mandate the form that any disclosures must take. Therefore, the Agencies should adopt a bifurcated approach in order to provide the most effective disclosure regime, which would encompass both general trading relationship conflict disclosures and transaction-specific disclosures, when appropriate.

These relationship-level disclosures are supplemented by the existing body of disclosure rules and anti-fraud and misrepresentation provisions at both the federal and state level (which include private rights of actions under those provisions), pursuant to which banking entities already provide to their counterparties extensive “risk disclosures,” including conflicts of interest, in the transaction level documents of many products. We do not believe that it is necessary for the Proposal, therefore, to mandate when additional transaction-specific disclosures are required.

Nonetheless, should the Agencies determine that it would be appropriate for certain transactions to be accompanied by transaction-specific disclosures, we recommend that the Agencies articulate a clearly defined standard for when transaction-specific disclosure is needed. Specifically, we believe that the Agencies should specify a predefined set of transactions, such as CSFTs, as the types of transactions for which transaction-specific disclosure is required under the Volcker Rule. Targeting CSFTs would identify for the Agencies and banking entities a well-formulated universe of the transactions most likely to present unique conflict issues to counterparties and banks. Moreover, the scope of CSFTs is well understood in the industry and CSFTs encompass those transactions where there is sufficient time and opportunity in the structuring to allow for the development and consideration of customized disclosures.

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<sup>303</sup> In these situations, it would be nearly impossible to provide a client with the disclosure “sufficiently close in time to the client’s, customer’s, or counterparty’s decision to engage in the transaction or activity to give the client, customer, or counterparty an opportunity to meaningfully evaluate and, if necessary, take steps that would negate or substantially mitigate the conflict,” because it is the client who is seeking immediacy and demanding an immediate quote.

<sup>304</sup> Bank Holding Company Act § 13(d)(2)(A)(i) (as added by Dodd-Frank § 619).

## B. Information Barriers

**Recommendation:** The Agencies should confirm that a banking entity may conclusively rely on information barriers to avoid a “material conflict of interest.”<sup>305</sup>

The Proposal also recognizes that informational barriers are a separate and independently sufficient method of mitigating or negating potential material conflicts of interests.<sup>306</sup> The effectiveness of information barriers in addressing antifraud concerns arising from asymmetries of information is well-established.<sup>307</sup> As an alternative to disclosure, we believe that the Agencies should embrace, as much as possible, the use of information barriers to mitigate material conflicts of interest.

The Proposal, however, contains a potential internal inconsistency: the rule both permits the use of barriers to avoid conflicts and simultaneously rejects the use of barriers if there is a conflict that the banking entity knows or has reason to know will potentially harm customers. The fundamental purpose of an information barrier is to permit (and, in fact, require) certain units of a firm to operate independently. We doubt that the Agencies intended to undermine that sound policy goal. Our understanding is that this provision in the rule was meant to prevent a banking entity from relying on an information barrier if a person on one side of the barrier knows that the banking entity’s interests are materially adverse to those of a counterparty to a transaction on the other side of the barrier. But this would defeat the purpose of the barrier because knowledge would be imputed from one side of the barrier to the other. Instead, this provision should provide that a banking entity may not rely on the information barrier if it knows, or should reasonably know, that the policies, procedures and controls establishing the barrier would not be effective in restricting the spread of information.

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<sup>305</sup> We believe this section is responsive to Questions 190 and 207 in the Proposal.

<sup>306</sup> Proposal § .8(b)(2).

<sup>307</sup> *See, e.g.*, the Reg SHO definition of aggregation unit and Section 15(g) and Rule 10b-1 of the Exchange Act.

### C. Asset-Backed Securities

**Recommendation:** Conflicts of interests relating to asset-backed securities should be exempted by the Proposal and addressed solely through Section 621.<sup>308</sup>

We note that Section 621 of the Dodd-Frank Act, as implemented by Rule 127B, was intended to address material conflicts of interest for asset-backed securities. We are submitting comments on proposed Rule 127B in a separate comment letter and believe that Rule 127B, amended as suggested in our comment letter, will adequately address conflicts of interest relating to asset-backed securities. As such, the Proposal should carve out asset-backed securities that are governed by Rule 127B and state that compliance with that rule will be deemed compliance with the Volcker Rule, as to those asset-backed securities.

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<sup>308</sup> We believe this section is responsive to Question 211 in the Proposal.



## IX. Foreign Exchange

### A. Application to Foreign Exchange Swaps and Forwards

**Recommendation:** The Volcker Rule’s proprietary trading restrictions should not be applied to the well-functioning markets for foreign exchange swaps and forwards, which are integral to global payments and monetary policy and meet essential needs of a broad range of market participants, including small businesses and other end users.<sup>309</sup>

The Proposal excludes spot foreign exchange transactions from the definition of “covered financial position” but explicitly includes foreign exchange swaps and forwards, subjecting them to the Volcker Rule’s proprietary trading restrictions. We believe this is not required by the statute and leads to unintended consequences that pose serious risks to markets and participants.

Foreign exchange is the world’s largest financial market and a central component of the global payments system. The Bank for International Settlements (“**BIS**”) estimates that average daily market turnover in foreign exchange increased to \$4 trillion in April 2010, up from \$3.3 trillion in April 2007.<sup>310</sup> Foreign exchange swaps and forwards are overwhelmingly instruments with short maturities,<sup>311</sup> and institutions across the globe rely heavily on them to fund their commercial and other payment obligations.

Currency trading has been an essential element of banking and monetary policy in the U.S. since the National Bank Act of 1863. As the Treasury Secretary acknowledged in a statement before the Senate Committee on Agriculture, Nutrition and Forestry in December 2009, foreign exchange markets during the recent financial crisis “actually worked quite well.”<sup>312</sup> Because transactions in foreign exchange forwards and swaps are integral to the global payments system and to monetary policy, it is essential that the smooth functioning of these markets not be disrupted.

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<sup>309</sup> We believe this section is responsive to Questions 52 and 55 in the Proposal.

<sup>310</sup> BIS, Monetary and Economic Department, *Triennial Central Bank Survey: Report on Global Foreign Exchange Market Activity in 2010*, at 6 (Dec. 2010) (“BIS Survey”).

<sup>311</sup> Of daily traded volume in 2007, more than 98% of foreign exchange forwards and 99% of foreign exchange swaps were of maturities of less than a year. See Oliver Wyman, *Proposed EU Commission Financial Transaction Tax Impact Analysis on Foreign Exchange Markets*, at 8 (Jan. 2012) (citing BIS data).

<sup>312</sup> *OTC Derivatives Reform and Addressing Systemic Risk: Hearing Before S. Comm. on Agric., Nutrition & Forestry*, 111th Cong. 802 (Dec. 2, 2009) (Testimony of Timothy Geithner, Secretary of the Treasury).

As proposed, the Volcker Rule regulations would significantly impede typical foreign exchange activity and, as a result, adversely impact liquidity in this well-established, efficient and liquid market. Market makers in foreign exchange forwards frequently warehouse risk before it can be effectively hedged, particularly late in the U.S. trading day when there may be no liquidity in Asian currencies or in the Euro until the next day. If the Volcker Rule effectively restricts market makers from potential appreciation in value of positions that may be needed to provide such liquidity, then market makers will be reluctant to operate in the foreign exchange market during these sensitive late-day periods. The Proposal's restriction on holding inventory will impose additional costs on this market and hinder dealers' ability to quote prices in a timely and accurate manner, especially for transactions of large size.

As foreign exchange is instrumental in conducting monetary policy, this decrease in liquidity will significantly impact the U.S. government's ability to set such policy. This stands in stark contrast to congressional intent as evidenced in the explicit permitted activity for trading in U.S. government securities. Approximately 85% of foreign exchange trades involve the U.S. dollar,<sup>313</sup> and more than 60% of foreign exchange reserves are held in U.S. dollars or in U.S. dollar-denominated assets.<sup>314</sup> More international contracts are denominated in U.S. dollars than in any other currency,<sup>315</sup> and during economic turmoil investors tend to buy U.S. Treasury bonds. The resulting demand for U.S. dollars reduces borrowing costs for U.S. corporations, individuals and the U.S. Treasury, and reduces foreign exchange risk for U.S. corporations, as it increases liquidity in the market for U.S. dollars. The Proposal may also encourage foreign exchange activity to be executed offshore because those markets will be more liquid and less costly, making intervention by the Board less feasible and potentially placing oversight over the foreign exchange markets beyond the reach of U.S. regulators. Today, only 18% of foreign exchange transactions involving the U.S. dollar occur within U.S. borders. Imposition of the Proposal's restrictions would undoubtedly exacerbate this migration.

Moreover, the reduction of liquidity in the foreign exchange markets will lead to significant increases in transaction costs, volatility, and currency risk for market participants more broadly. Corporate end users, which rely upon foreign exchange forwards and swaps to hedge risks and adjust timing of currency payments and deliveries to match their business needs, will face increased costs associated with the reduced liquidity in these markets. This will make it more difficult to meet ongoing needs, particularly for those involved in the export/import of products and services. The Proposal will also have the

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<sup>313</sup> BIS Survey at 9.

<sup>314</sup> See International Monetary Fund, *Currency Composition of Official Foreign Exchange Reserves* (Second Quarter of 2010).

<sup>315</sup> New York Federal Reserve Foreign Exchange Committee, *Overview of the OTC Foreign Exchange Market: 2009*, at 2-3 (2009).

potential effect of disrupting the activities of central banks. Foreign exchange swaps and forwards are fundamental tools used by central banks to manage liquidity and market stability, and their importance and prevalence are increasing.<sup>316</sup> Diminished liquidity caused by the Proposal will make it more difficult for central banks to manage fluctuations in currency values.

These effects will not be limited to the foreign exchange swaps and forwards themselves—since the spot, foreign exchange swap and foreign exchange forwards markets are all heavily interlinked, the restrictions placed on activity in respect of foreign exchange forwards and swaps could also negatively impact liquidity in the spot market, further hurting the end user.<sup>317</sup> The effects will be particularly acute during times of market impairment, as the Proposal would impede the ability of banks to warehouse risk and to take positions that help to alleviate the pressures imposed when there is broad credit deterioration.

## B. Definition of Derivative

**Recommendation:** The Agencies are not required to, and should not, include foreign exchange swaps and forwards in the definition of “derivative.”<sup>318</sup>

The statutory Volcker Rule restricts proprietary trading in any security, futures contract or derivative.<sup>319</sup> None of these terms are defined in the statute. In the Proposal, however, the Agencies have explicitly included foreign exchange swaps and forwards within the definition of “derivative.”<sup>320</sup> We believe that this inclusion is inappropriate and does not comport with congressional intent as stated elsewhere in Dodd-Frank.

Section 721 of Dodd-Frank<sup>321</sup> explicitly permits the Treasury Secretary to exclude foreign exchange swaps and forwards from regulation as “swaps” for most Title VII

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<sup>316</sup> To illustrate the relationship between foreign exchange and monetary policy: Interest rate movements directly influence exchange rates, and the exchange rate affects demand for exports. The demand for exports in turn affects (i) output in the United States, (ii) international competitiveness and (iii) the composition of the U.S. gross domestic product. Similarly, exchange rates affect the dollar-price of imports, which in turn affects inflation.

<sup>317</sup> Market makers manage their inventories in currencies across delivery dates. To give effect to the exemption for foreign exchange spot and to avoid the unintended consequence of adversely affecting liquidity and pricing in the foreign exchange spot market, the Agencies should similarly exclude foreign exchange swaps and forwards.

<sup>318</sup> We believe this section is responsive to Questions 52 and 55 in the Proposal.

<sup>319</sup> Bank Holding Company Act § 13(h)(4) (as added by Dodd-Frank § 619).

<sup>320</sup> Proposal § .2(l)(i)(C).

<sup>321</sup> See Commodity Exchange Act § 1a(47)(E) (as amended by Dodd-Frank § 721).

purposes.<sup>322</sup> The Treasury Secretary has proposed doing so,<sup>323</sup> recognizing that foreign exchange swaps and forwards are different from and do not pose the same risks as other “swaps” under Title VII. In its proposal to exempt foreign exchange swaps and forwards under Title VII, the Treasury Department differentiated these instruments, noting “unlike most other derivatives, foreign exchange swaps and forwards have fixed payment obligations, are physically settled, and are predominantly short-term instruments,” resulting “in a risk profile that is different from other derivatives.”<sup>324</sup>

Just as Treasury has proposed excluding foreign exchange swaps and forwards from regulation as swaps under Title VII, we believe the Agencies should exclude these instruments from the definition of derivative in the Volcker Rule.<sup>325</sup> Specifically, we believe the term “derivative” in the statute should not be defined in the Proposal to capture these deliverable currency transactions because such transactions are an integral part of the cash market, and their only “derivative” characteristic that distinguishes them from foreign exchange spot transactions is that actual delivery takes place at a point in time longer than two business days. For example, a foreign exchange forward is essentially an exchange of two physical currencies at a date in the future. Except for the fact that it is a longer dated instrument than a foreign exchange spot transaction, it is largely the same instrument. Likewise, a foreign exchange swap is not a derivative in the traditional sense: it embodies an exchange of currencies within a funding transaction, whereby one party borrows a currency from another party and simultaneously lends to that same party another currency with a redelivery of each such currency on the maturity date. In short, as Treasury has said, these instruments are “different from other derivatives.” Thus, we believe excluding foreign exchange swaps and forwards from the definition of “derivative” is consistent with congressional intent and the policy goals of the Volcker Rule.

We also note that while the Agencies have appropriately made the policy judgment to explicitly exclude spot foreign exchange positions from the definition of “covered financial position,”<sup>326</sup> the rule text—specifically Section \_\_.3(b)(3) of the proposed rules—would be clearer by express reference to “spot foreign exchange or currency.” And, as

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<sup>322</sup> The Treasury Secretary is not permitted to exclude foreign exchange swaps and forwards from swap data repository reporting requirements or a number of business conduct-related provisions. These provisions do not implicate Volcker Rule-related concerns.

<sup>323</sup> Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25,774 (proposed May 5, 2011).

<sup>324</sup> *Id.* at 25,776.

<sup>325</sup> Congress could not have intended for “derivative” to be construed so broadly in the statutory Volcker Rule as to encompass everything commonly known as a “derivative” because the statute lists commodity futures and options on a security—also derivatives—as separate categories.

<sup>326</sup> The Preamble suggests spot foreign exchange is excluded. *See* Proposal at 68,850 (FRB 12) (noting “covered financial position” does not include positions in “spot foreign exchange”).

discussed above, the linkage of currency swap, forward and spot markets makes it essential to apply this exclusion across these interdependent markets.

### C. Trading Account

**Recommendation:** If the Agencies choose to include foreign exchange swaps and forwards within the definitions of “derivative” and “covered financial position,” transactions in these instruments should be excluded from a banking entity’s trading account.<sup>327</sup>

The Proposal excludes purchases and sales of covered financial positions in connection with repo transactions from a banking entity’s trading account. The Agencies state that repo transactions operate as secured loans and are not entered into based on expected movements in asset prices.<sup>328</sup> Essentially, the Agencies have rightfully determined that repos are funding transactions and are a traditional banking activity like lending and deposit-taking. The same logic applies to an exclusion for foreign exchange swaps and forwards.

Like repos, foreign exchange swaps and forwards “are not based on expected or anticipated movements in asset prices” and should not be considered part of the trading account. As described above, a foreign exchange swap comprises a funding transaction similar to a repo contract.<sup>329</sup> Foreign exchange swaps are used primarily for hedging and are perhaps the most efficient short-term funding vehicle worldwide. During the financial turmoil following the failure of Lehman Brothers, global financial institutions turned to the foreign exchange swap market as a “primary channel for raising dollar funding.”<sup>330</sup> Likewise, foreign exchange forwards are a traditional banking activity that is economically indistinguishable from loans and deposits.<sup>331</sup> The Treasury Department’s proposal to exempt foreign exchange swaps and forwards from the definition of “swap” under Title VII of Dodd-Frank notes specifically that features such as fixed and predetermined payment obligations “make foreign

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<sup>327</sup> We believe this section is responsive to Questions 20 and 43 in the Proposal.

<sup>328</sup> Proposal at 68,862 (FRB 37).

<sup>329</sup> The BIS has characterized foreign exchange swaps as “effectively collateralized transactions.” BIS, *From Turmoil to Crisis: Dislocations in the FX Swap Market Before and After the Failure of Lehman Brothers*, at 2 (2009).

<sup>330</sup> *Id.* at 6.

<sup>331</sup> The rates of foreign exchange forwards are established using spot rate and interest rate differentials between two currencies.

exchange swaps and forwards more similar to funding instruments, such as repurchase agreements, which are not covered under the [Commodity Exchange Act].”<sup>332</sup>

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<sup>332</sup> Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25,774, 25,776 (proposed May 5, 2011).

## X. Compliance and Quantitative Metrics

### A. Approach to Compliance and Metrics

**Recommendation:** As the FSOC has suggested, the Agencies should implement the Volcker Rule through a combination of internal compliance policies and procedures, reporting and review of quantitative metrics and supervisory review.<sup>333</sup>

As stated above, we believe that the Agencies should monitor a banking entity's compliance with permitted activities through guidance incorporated into banking entities' policies and procedures, which would include risk limits and controls monitored by the Agencies through examinations. Certain quantitative metrics may be used to highlight data that would be informative to the Agencies and could be discussed with examiners and in the context of horizontal reviews. However, these metrics should not be bright-line triggers for remedial action. Some metrics may be more relevant than others for the particular asset class, activity, market and unique characteristics of each banking entity for which they are being measured.

In applying any metric, the Agencies must recognize that the relevance of the metric, the utility of the data produced and the difficulty of collecting the data will differ by entity and by activity. The metrics will thus need to be applied flexibly enough to accommodate these differences in methodology between banking entities and asset classes.

We believe that this approach strikes the right balance of ensuring compliance with the statutory Volcker Rule while allowing banking entities the necessary flexibility to engage in those activities Congress has specifically identified as critical for the financial system. It will embrace, rather than reject, the differences between banking entities, activities and asset classes that provide customers with critical services.

This is also the approach advocated by the FSOC in its study on implementation of the Volcker Rule. In its study, the FSOC states that "one benefit of these approaches is that they are likely to be mutually reinforcing and provide a comprehensive regulatory framework; a programmatic compliance regime, supplementary reporting and review of quantitative metrics and supervisory review might be designed to work in concert to constrain proprietary trading ex ante and identify potentially problematic trading activity ex post."<sup>334</sup> As the FSOC's study was mandated by Congress as a step toward the Agencies'

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<sup>333</sup> We believe this section is responsive to Questions 143 and 146 in the Proposal.

<sup>334</sup> FSOC Study at 32.

rulewriting,<sup>335</sup> we believe it should be given significant weight in consideration of the final rule.

In general, we believe that the compliance and metrics requirements the Agencies have proposed, including the more tailored compliance requirements in § \_\_.20(a) and (b) of the Proposal for entities with smaller trading volumes, provide a starting point for the compliance and metrics regime outlined above. In the remainder of this section, we provide specific comments on elements of those requirements.

## B. Level of Trading Unit

**Recommendation:** “Trading unit” should be defined at a level that presents its activities in the context of the whole. The appropriate level may differ depending on the structure of a banking entity.<sup>336</sup>

The Proposal requires banking entities with more than \$1 billion in average trading assets and liabilities to calculate quantitative metrics and comply with many of Appendix C’s requirements on a trading unit basis.<sup>337</sup> “Trading unit” is a multi-level definition.<sup>338</sup> It starts with “each discrete unit that is engaged in the coordinated implementation of a revenue-generation strategy and that participates in the execution of any covered trading activity,” which the Agencies note will generally be the “smallest unit of organization used by the covered banking entity to structure and control its risk-taking activities and employees, and will include each unit generally understood to be a single ‘trading desk.’”<sup>339</sup> Each such trading unit is rolled up into a larger level trading unit, composed of “each organizational unit that is used to structure and control the aggregate risk-taking activities and employees of one or more trading units” described above.<sup>340</sup> The Agencies note that they expect this level of trading unit to “generally include management or reporting divisions, groups, subgroups, or other intermediate units of organization used by the banking entity to manage one or more discrete trading units (e.g., “North American Credit Trading,” “Global Credit Trading”).”<sup>341</sup> These trading units, in turn, are rolled up to create a

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<sup>335</sup> Bank Holding Company Act § 13(b)(1) (as added by Dodd-Frank § 619).

<sup>336</sup> We believe this section is responsive to Questions 156, 157, 160 and 366 in the Proposal.

<sup>337</sup> See Proposal § \_\_.7(a).

<sup>338</sup> See Proposal, Appendix A § II.

<sup>339</sup> *Id.* § II and n.1.

<sup>340</sup> *Id.* § II.

<sup>341</sup> See *id.* at n.2.



trading unit out of all trading operations of the banking entity.<sup>342</sup> Finally, the Agencies provide themselves the ability to specify any other unit of organization in a particular banking entity as a “trading unit.”

We agree that a multi-level approach to “trading unit” is appropriate and will help the Agencies view activities holistically and in context. Carefully designing the scope of a trading unit is critical to presenting an accurate portrayal of the unit’s activities. Moreover, scattershot definitions of trading unit raise the compliance and metrics recording burdens for banking entities. Therefore we believe that the Agencies must ensure that trading unit is not defined so granularly that it captures only a portion of a unit’s activities rather than the activity as a whole. If trading units are defined too granularly, reported quantitative metrics will be overly volatile<sup>343</sup> and uninformative to the Agencies and will yield many “false positives.” Furthermore, it will increase the burden of calculating and reporting metrics for many separate units.

The appropriate level of granularity for a “trading unit” is likely to depend on the structure of the individual banking entity, activity and involved asset classes. This is a difficult determination that will require the Agencies to learn about individual banking entities, their activities and the differences between asset classes, which can be accomplished during the statutory conformance period.<sup>344</sup> Thus, in order to ensure that “trading unit” is not defined at too granular a level and that the decision of what should constitute a “trading unit” is made on an informed basis, we believe the Agencies should initially define “trading unit” on a broader level and use the information gathered during the conformance period to narrow the definition as needed. While additional data are necessary to determine the proper level of granularity, we believe the appropriate levels may be either the levels at which banking entities set budgets, risk metrics and other mandates or the levels at which banking entities currently engage with their prudential regulators. We believe these levels generally represent the functional units within a banking entity and will align with customers’ understanding of the entities with which they are conducting business.

Further, hedging operations, even for an individual trading desk, may involve several booking vehicles. As a result, it is critical that compliance should not be calculated on an entity-by-entity basis, but must take into account the operations across banking entities.

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<sup>342</sup> *See id.* § II.

<sup>343</sup> Relatedly, we believe that the Agencies should not choose calculation periods for the metrics that are so short as to lead to overly volatile results, regardless of the level at which they are calculated. The appropriate calculation period will differ depending on the relevant metric. For example, we believe that Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss should be measured using a rolling one-year calculation period rather than the 30, 60 and 90 day calculation periods proposed. *See id.* § IV.C.4.

<sup>344</sup> *See* the discussion beginning on page A-106.

## C. Thresholds

**Recommendation:** The Agencies should not impose thresholds for quantitative metrics but should use the metrics to highlight opportunities for further discussion.<sup>345</sup>

We agree with the FSOC<sup>346</sup> and the Proposal<sup>347</sup> that the quantitative metrics should be used by the Agencies not as a dispositive tool, but to highlight opportunities for further discussion of the activities of the trading unit. We think that the Agencies should make such a determination based not on hard-coded thresholds for each metric, but should endeavor to understand how metrics differ among banking entities, trading units, asset classes, activities and market conditions.<sup>348</sup> In the words of the FSOC, “metrics are best utilized by Agencies as a key source of information for identifying potentially problematic trading activities that may require further study, rather than a comprehensive, dispositive tool.”<sup>349</sup>

In addition, the FSOC noted that “the relevance or utility of any particular metric may vary significantly depending on the asset class, liquidity, trading strategy and market profile of the trading activity in question.”<sup>350</sup> As discussed below, different banking entities may be structured differently, combining more or fewer activities into a single trading

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<sup>345</sup> We believe this section is responsive to Questions 155, 187, 188 and 189 in the Proposal.

<sup>346</sup> See FSOC Study at 37.

<sup>347</sup> See Proposal, Appendix A § I.

<sup>348</sup> We understand that the Agencies do not intend to set specific thresholds or ranges for these quantitative metrics. If the Agencies do specify thresholds or ranges for quantitative metrics, they must repropose because there are currently no such thresholds or ranges upon which regulated entities can provide comment; the regulated entities literally would have to “divine the agenc[ies]’ unspoken thoughts.” *CSX Transp., Inc. v. Surface Transp. Bd.*, 584 F.3d 1076, 1080 (D.C. Cir. 2009). An agency’s final rule must be a “logical outgrowth” of its proposal. *Envtl. Integrity Project v. EPA*, 425 F.3d 992, 996 (D.C. Cir. 2005). A final rule is a logical outgrowth of a proposal if interested “part[ies], *ex ante*, should have anticipated” the final rule in light of the agency’s initial notice of proposed rulemaking, *Az. Pub. Serv. Co. v. EPA*, 211 F.3d 1280, 1299 (D.C. Cir. 2000), and “thus reasonably should have filed their comments on the subject,” *Ne. Md. Waste Disposal Auth. v. EPA*, 358 F.3d 936, 952 (D.C. Cir. 2004). “[A] final rule fails the logical outgrowth test . . . where interested parties would have had to divine the agency’s unspoken thoughts, because the final rule was surprisingly distant from the proposed rule.” *CSX Transp., Inc. v. Surface Transp. Bd.*, 584 F.3d 1076, 1080 (D.C. Cir. 2009).

<sup>349</sup> FSOC Study at 37.

<sup>350</sup> *Id.* Similarly, we agree with the FSOC’s suggestion that “In addition to establishing a programmatic compliance regime as part of a comprehensive implementation framework, the Council recommends that Agencies consider requiring banking entities to report and supervisors to review quantitative metrics that may assist Agencies in identifying potential impermissible activities. Such an approach would be designed to provide Agencies with an objective set of data that (i) brings to supervisory attention trading trends or incidents that may suggest that violations have occurred and (ii) facilitates the comparison of such trading data across banking entities, market segments, or trading strategies to inform and strengthen the supervisory process. Agencies should consider utilizing an array of metrics when reviewing trading activity.” *Id.* at 36.

unit or engaging in activities across multiple banking entities, which will change what constitutes “appropriate” levels for each metric. Appropriate metrics levels will also differ by asset class and some metrics may not be relevant. Metrics levels will also vary by type of activity—VaR value for cash equity trading may be different from VaR value for distressed debt trading, for example. Finally, during times of market stress and volatility, risk metrics may be significantly higher than during normal times. Similarly, Inventory Risk Turnover will vary significantly by asset class, as described in more detail below.<sup>351</sup>

We understand, as do the Agencies,<sup>352</sup> that this task is difficult and that it will take time for banking entities and the Agencies to develop a sense of appropriate ranges for the quantitative metrics. We believe that the statutory full two-year conformance period, however, is a critical time period to begin this task. The Agencies can educate themselves through meetings with market participants regarding their activities and by collecting relevant indicative metrics as well as determinations from the banking entities as to what ranges, if applicable, are appropriate for specific activities.<sup>353</sup> On July 21, 2014, after the statutory conformance period is complete, the Agencies can require an appropriate set of banking entities to report all or some metrics, and use this reporting together with received knowledge to begin reviewing reported quantitative metrics.<sup>354</sup>

#### D. Problematic Metrics

**Recommendation:** The Agencies should not require the Spread Profit and Loss, VaR Exceedance, Comprehensive Profit and Loss Attribution and Pay-to-Receive Spread Ratio metrics.<sup>355</sup>

Metrics that are flexible and can account for different types of activities and asset classes, such as the Risk Factor Sensitivities metric,<sup>356</sup> will be useful in helping the

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<sup>351</sup> See the discussion beginning on page A-112.

<sup>352</sup> The Agencies note that “quantitative measurements can only be usefully identified and employed after a process of substantial public comment, practical experience, and revision” and that “[a]dditional study and analysis will be required before quantitative measurements may be effectively designed and employed.” Proposal at 68,883 (FRB 83).

<sup>353</sup> See Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 FR 8,265 (Feb. 14, 2011) (“**Conformance Rule**”); see also discussion beginning on page A-119.

<sup>354</sup> See the discussion beginning on page A-119.

<sup>355</sup> We believe this section is responsive to Questions 168, 170, 174, 175 and 363 in the Proposal.

<sup>356</sup> We understand the Risk Factor Sensitivities metric to require banking entities to describe the key factors used to measure, monitor and manage risk in a manner consistent with the way banking institutions already do so for purposes of calculating VaR under existing regulatory guidance.

Agencies determine whether a reporting trading unit’s activity warrants further investigation. Below, we provide specific suggestions on ways to improve the metrics proposed by the Agencies. However, we believe that the Spread Profit and Loss, VaR Exceedance, Comprehensive Profit and Loss Attribution and Pay-to-Receive Spread Ratio metrics are fundamentally flawed and should be removed from the list of required metrics. We believe these metrics would not provide the Agencies with useful data to determine where further investigation would be appropriate. As a result, a cost-benefit analysis would not justify including them.

The Agencies define the Spread Profit and Loss (“**Spread P&L**”) metric as the “portion of Portfolio Profit and Loss that generally includes revenue generated by a trading unit from . . . charging a ‘spread.’”<sup>357</sup> The Spread P&L metric assumes that changes in the value of a portfolio can be instantaneously broken up into a “spread” component and a “market move” component. We do not believe this is true, as stated above in our discussion of the “sources of revenue” factor in the market making-related permitted activity.<sup>358</sup> The Agencies do recognize in Appendix A that a bid and ask for the financial instrument in question may not be widely disseminated, but assume that, in such a case, it can be estimated using an end-of-day spread proxy, historical data spread proxy or other appropriate proxy.<sup>359</sup> We disagree and think this is an unhelpful and unrealistic perspective on a trading unit’s activities and revenues.<sup>360</sup> As a result, we believe this metric should be removed. To the extent other metrics incorporate Spread P&L, those metrics should be adjusted to remove any such reference.<sup>361</sup>

The Spread P&L metric, and its emphasis on the source of profit and loss, implicates other hard-coded factors in the rule that we suggest be moved to guidance. For example, the Proposal requires that compensation arrangements of employees involved in market-making activities be “designed not to reward proprietary risk-taking.”<sup>362</sup> We believe that if a compensation standard is retained, greater clarity would be needed. At a minimum,

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<sup>357</sup> Proposal, Appendix A § IV.B.4. We understand the Comprehensive Profit and Loss to be the sum of Spread P&L, Portfolio Profit and Loss and fees and expenses, and that the definition of Portfolio Profit and Loss does not include Spread P&L.

<sup>358</sup> See the discussion beginning on page A-30.

<sup>359</sup> See Proposal, Appendix A § IV.B.4.

<sup>360</sup> See the discussion beginning on page A-30.

<sup>361</sup> For example, the Volatility of Portfolio Profit and Loss, Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days Based on Portfolio Profit and Loss and Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss metrics all calculate values excluding Spread P&L. The Pay-to-Receive Spread Ratio also incorporates Spread P&L but, as discussed below, we believe this metric is problematic and should be removed entirely.

<sup>362</sup> Proposal § \_\_.4(b)(2)(vii).

the word “prohibited” should be added to confirm that the standard is referring to a system “designed not to reward prohibited proprietary risk-taking.”<sup>363</sup>

A meaningful measure for Spread P&L cannot be calculated in the absence of a continuous bid-ask spread, which simply does not exist in most markets.<sup>364</sup> If the Agencies nonetheless retain this metric, we believe that banking entities should be able to report an estimate in the form of an end of day spread proxy, historical data spread proxy or other appropriate proxy as allowed by the Proposal, but should not bear the burden of proving that no bid-ask spread is widely disseminated or that the particular proxy used is best. We believe these requirements increase the burden on banking entities with no additional benefit.<sup>365</sup> In addition, while as stated above we do not believe that thresholds should be imposed on any reported metric, we believe this is particularly important in the case of Spread P&L or any similar metric used by the Agencies due to the significant differences in asset classes.

Similarly, we do not believe the benefits of the Comprehensive Profit and Loss Attribution metric justify its costs. We believe that the useful information that the Agencies will learn from the Risk Factor Sensitivities will not be enhanced by attributing Comprehensive Profit and Loss to particular risk factors because most of the components of Comprehensive Profit and Loss not already included in Risk Factor Sensitivities are not sensitive to the risk factors (*e.g.*, carry costs). In addition, due to the potential for correlation between risk factors, different results for this metric would arise depending on the order in which the attribution is done, providing unreliable signals. Finally, this metric would be costly for banking entities to implement. As a result, we believe that the cost of this metric cannot be justified by the minimal benefits, and the metric should be removed. To the extent it is not removed, the Agencies must ensure it can be calculated by each institution in a way that reflects that institution’s unique characteristics.

We also believe the VaR Exceedance metric should be eliminated. The VaR Exceedance metric is defined as the difference between VaR and the Portfolio Profit and Loss, exclusive of Spread Profit and Loss. As such, the VaR Exceedance metric is a measure of the quality of a trading unit’s modeling rather than an indicator that a trading unit is operating outside the bounds of the permitted activities or has taken on excessive risk. As a result, we believe the metric is unhelpful, is beyond the Agencies’ statutory Volcker Rule mandate and should be removed.

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<sup>363</sup> While our point here is being made in the context of the market making-related permitted activity, it is equally applicable to the underwriting and risk-mitigating hedging permitted activities.

<sup>364</sup> We are also concerned that, even in cases where it might be possible to calculate the Spread P&L, doing so would require the “tagging” of individual trades and would thus be unduly burdensome on reporting entities.

<sup>365</sup> See Proposal, Appendix A § IV.B.4.

Similarly, we believe the Pay-to-Receive Spread Ratio is not useful and should be discarded. First, as Pay-to-Receive Spread Ratio is defined as the “ratio of amount of Spread Profit and Loss and Fee Income that is earned by a trading unit to the amount of Spread Profit and Loss and Fee Income that is paid by the trading unit,” it is a subsidiary metric of Spread P&L and is problematic for the reasons discussed above with respect to Spread P&L. In addition, this metric requires a trade-by-trade analysis and is thus expensive to compute. We do not believe it provides any additional information to the Agencies beyond what is available from other metrics.

## E. Customer-Facing Trade Ratio

**Recommendation:** The Customer-Facing Trade Ratio is flawed. Instead, the Agencies could require each institution to provide information on activities by class of counterparty.<sup>366</sup>

The Customer-Facing Trade Ratio is defined as “a ratio comparing the number of transactions involving a counterparty that is a customer of the trading unit to the number of transactions involving a counterparty that is not a customer of the trading unit.”<sup>367</sup> We believe that the metric, as currently formulated, is flawed. First, since trades may be of different sizes and risks, reliance on the number of transactions as the input to this ratio is problematic. For example, a trading unit may as part of its permitted market making-related activities execute a large block transaction with a customer. The trading unit may hedge that block trade through a number of smaller transactions with dealers. If the trading unit, for example, enters into five smaller hedge transactions, the Customer-Facing Trade Ratio would appear to be 1/5, which could raise a red flag for the Agencies. Instead, the Customer-Facing Trade Ratio should be based on a risk-aware metric. In the scenario outlined above, this would likely be close to 1/1, which would more accurately reflect the reality that the trading unit is entering into transactions with non-customers to hedge its transactions with customers.

Perhaps more importantly, the usefulness of a Customer-Facing Trade Ratio fundamentally depends on the definition of “customer.” The description of the Customer-Facing Trade Ratio provides that, “a counterparty is considered to be a customer of the trading unit if the counterparty is neither (i) a counterparty to a transaction executed on a designated contract market registered under the Commodity Exchange Act or national securities exchange registered under the Exchange Act, nor (ii) a broker-dealer, swap dealer, security-based swap dealer, any other entity engaged in market making-related activities, or

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<sup>366</sup> We believe this section is responsive to Questions 168 and 174 in the Proposal.

<sup>367</sup> Proposal, Appendix A § IV.D.3.

any affiliate thereof.”<sup>368</sup> The determination in prong (i) is absolute, but the determination in prong (ii) is rebuttable if the “banking entity treats that entity as a customer and has documented how and why the entity is treated as such.”<sup>369</sup>

We believe that the statement that a counterparty cannot be considered a customer if the transaction is executed on a designated contract market registered under the Commodity Exchange Act or national securities exchange registered under the Exchange Act fails to account for the important role electronic and algorithmic market makers play in creating markets for participants on such exchanges. These market makers submit ongoing bids and offers to an exchange. Such quotes are critical to the existence of liquid markets and, we believe, should be encouraged rather than discouraged by the Agencies.

In addition, the presumption that a registered entity or affiliate by definition is not a customer is problematic and contradicts informative statements made by the Agencies elsewhere in the Proposal. In Appendix B, the Agencies note that “customer” can include other dealers or registered entities, noting that “in the context of market making in a covered financial position in an over-the-counter market, a ‘customer’ generally would be a market participant that makes use of the market’s maker intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services.”<sup>370</sup> Similarly, the Preamble notes that “a market maker’s ‘customers’ generally vary depending on the asset class and market in which the market maker is providing intermediation services” and that “in certain cases, depending on the conventions of the relevant market (e.g., the over-the-counter derivatives market), ... a ‘customer’ may consider itself or refer to itself more generally as a ‘counterparty.’”<sup>371</sup> We believe that these statements, which recognize the complex relationships between market participants that may be customers, are correct in allowing dealers and other registered market participants to be treated as “customers” of a banking entity.

Finally, we believe that the individual tagging of trades as “customer” or “non-customer” trades will be incredibly burdensome if not impossible. Since the same counterparty may be acting as a “customer” for one transaction and hedge counterparty for another, banking entities will have to engage in constant analyses as to the purpose of each transaction and the status of its counterparty. We believe this would be unhelpful, overly burdensome and fraught with interpretive difficulty. Hence, the concept of “customers” and “non-customers” of a market maker is inapposite to the nature of market making. The Agencies should recognize that every counterparty of a market maker is in fact a customer.

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<sup>368</sup> *Id.*

<sup>369</sup> *Id.*

<sup>370</sup> Proposal, Appendix B § III.A.

<sup>371</sup> Proposal at 68,890 n.199 (FRB at 99 n.199).

Due to these flaws, we believe that the Customer-Facing Trade Ratio, in its current form, is invalid. Instead, the Agencies could require each institution to provide the Agencies with information on its activities by class of counterparty, such as by dealer vs. non-dealer.

## F. Inventory Aging and Inventory Risk Turnover

**Recommendation:** The Inventory Aging metric is only applicable to cash instruments and should not apply to derivatives. Additional changes to the Inventory Risk Turnover metric should be made to ensure it achieves its intended purpose.<sup>372</sup>

The Inventory Aging metric measures the “trading unit’s aggregate assets and liabilities and the amount of time that those assets and liabilities have been held,” thus giving a measure of the “age profile of the trading unit’s assets and liabilities.”<sup>373</sup> In requiring these metrics, the Agencies appear to be looking for instances where trading units are holding positions in inventory for longer periods of time than expected and, as a result, may not be engaging in active market making. While this metric may be useful in the cash market context, where the same instruments may be bought and sold, it is inapplicable to the derivatives markets. This was expressed in the FSOC study, which notes that “[f]or highly liquid financial instruments, inventory turnover and aging are relatively straightforward to measure as banking entities will have both significant daily volume and measurable inventories of each discrete asset. Such financial instruments include most cash equities . . . , commercial paper, and other financial instruments for which risk can be offloaded quickly.”<sup>374</sup> As a result, we believe that the Agencies should make clear that the Inventory Aging metric does not have to be calculated for derivatives transactions.<sup>375</sup>

The Inventory Risk Turnover metric is a ratio that “measures the amount of risk associated with a trading unit’s inventory, as measured by Risk Factor Sensitivities, turned over by a trading unit over a specified period of time.”<sup>376</sup> We believe this reliance on the measuring risk through the Risk Factor Sensitivities is appropriate. However, because

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<sup>372</sup> We believe this section is responsive to Questions 168, 174 and 175 in the Proposal.

<sup>373</sup> Proposal, Appendix A § IV.D.2.

<sup>374</sup> FSOC Study at 40.

<sup>375</sup> The Agencies should also make clear that the reference to aggregate “assets and liabilities” actually means “trading assets” – the description in the Proposal interchanges different terms which we believe is unintentional. The Agencies should also make clear that the calculation period is as of each day and not an average or sum over the 30, 60 or 90 day period.

<sup>376</sup> Proposal, Appendix A § IV.D.1.



certain Risk Factor Sensitivities will be more or less relevant depending on the particular instrument and trading unit, we believe that requiring risk turnover to be calculated for all of the regularly produced risk sensitivities is unhelpful and overly burdensome. As a result, we suggest that banking entities only be required to calculate the Inventory Risk Turnover with respect to the principal measure of directional risk for each trading unit. In addition, the definition of “Inventory Risk Turnover” may result in a measurement that does not adequately reflect risk turnover since the denominator is based on the static measure of holdings “at the beginning of the calculation period,” while the numerator is based on the sum of the absolute value of a transaction’s or group of transactions’ Risk Factor Sensitivities over the corresponding calculation period. If the net risk is low or zero at inception, the measure would show very high or infinite risk turnover. This issue can be addressed by defining “Inventory Risk Turnover” for each trading unit by using the sum of the absolute values of the Risk Factor Sensitivities associated with the transaction or group of transactions over the calculation period as the numerator (as defined in the Proposal) and the average of the absolute values of net Risk Factor Sensitivities over the calculation period as the denominator. Net Risk Factor Sensitivities would be calculated at close of business on each trading day of the calculation period. This proposed definition eliminates the bias introduced by using net risk at inception in the denominator and therefore provides a more meaningful metric.

## **G. Appendix C Compliance Regime**

**Recommendation:** The Appendix C compliance regime is overly specific, prescriptive and impractical. It should be replaced with a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations.<sup>377</sup>

Given our support above for a Volcker Rule regulatory regime modeled on indicative criteria of permitted activities bolstered by quantitative metrics, compliance and examinations,<sup>378</sup> we acknowledge the need for a robust compliance program to support the objectives of the rule. However, after careful review, we believe that the Appendix C compliance regime is overly specific, prescriptive and impractical. Banking entities should be permitted maximum flexibility to leverage and enhance existing compliance policies, procedures and protocols to implement aspects of Volcker compliance not currently in existence.

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<sup>377</sup> We believe this section is responsive to Questions 321, 322, 323 and 324 in the Proposal.

<sup>378</sup> See the discussion beginning on page A-103.

The compliance regime’s specificity stems from the mandate that written policies and procedures exist for each trading unit, including at the trading desk level. Appendix C repeatedly requires separate “written policies and procedures for each trading unit.”<sup>379</sup> By failing to allow for commonalities among trading units to be comprehensively addressed by the same policies and procedures, this requirement will force closely related trading units to duplicate their efforts. The prescriptiveness of this requirement will, as a result, make banking entities’ compliance programs less effective and efficient.

We believe that a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations is a better choice. This structure and these activities may differ materially by business unit, group and region, requiring that banking entities carefully assess them and tailor compliance policies and procedures to them in order for those policies and procedures to have any meaning.

In addition, we believe that a less specific and more flexible compliance regime is essential to give effect to enterprise-wide compliance structures, as contemplated in Appendix C. Requiring individualized policies and procedures for each business line effectively diminishes the benefits of an enterprise-wide compliance system and prevents consistency of these policies and procedures within the banking entity. For example, policies and procedures throughout the enterprise should require each trading desk to set risk limits. However, incorporating those actual risk limits into the policies and procedures makes it difficult, if not impossible, to use a standardized set of procedures throughout the enterprise.

## H. Leveraging Existing Compliance Regimes

**Recommendation:** The Agencies should permit banking entities to leverage existing compliance regimes, including the level at which compliance is monitored, in order to minimize inefficiencies, unnecessary expense and the potential for conflicting compliance protocols, including the use of existing Board governance protocols.<sup>380</sup>

As currently drafted, the Proposal could require banking entities to create an entirely new compliance architecture to serve as a banking entity’s Volcker Rule compliance

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<sup>379</sup> See Proposal, Appendix C § II.A (e.g. “The covered banking entity’s written policies and procedures for each trading unit must clearly articulate and document a comprehensive description of the mission (i.e., the nature of the business conducted) and strategy (i.e., business model for the generation of revenues) of the trading units. . .”).

<sup>380</sup> We believe this section is responsive to Questions 321, 328, 329, 360 and 370 in the Proposal.

program. Creating a *de novo* compliance program would be prohibitively expensive, unreasonably time-consuming and, ultimately, unnecessary. In addition, redundancies, inefficiencies and potentially conflicting policies and procedures could result from establishing a stand-alone compliance infrastructure for Volcker Rule compliance. Accordingly, the rule should be amended to clarify that firms are permitted and encouraged to leverage existing compliance infrastructure, policies and procedures.

For example, the Proposal would require the board of directors to review a banking entity's Volcker Rule compliance program as well as perform a number of direct oversight activities.<sup>381</sup> Large, complex banking entities have developed board of director reporting and governance processes over time to ensure that their compliance programs work appropriately. We believe these existing processes should be leveraged in a final rule that permits banking entities to use existing reporting, escalation, approval and other protocols to accomplish appropriate management and board of directors oversight of the Volcker Rule compliance program. Such flexibility will serve to reduce potential inefficiencies and facilitate banking entities' overall ability to successfully administer Volcker Rule compliance programs.

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<sup>381</sup> See Proposal, Appendix C § IV.

## XI. Supervisory Coordination

### A. Coordination Between Regulators

**Recommendation:** In order to avoid the confusion and costs of multiple overlapping regulators, we believe that the Agencies should provide in the final rules that: (i) the Board will have exclusive authority to interpret the Volcker Rule and the final rules; (ii) where more than one Agency has examination authority over a given banking entity, the appropriate Agencies will engage in a coordinated examination of such banking entity under the Volcker Rule; and (iii) an enforcement action under the Volcker Rule may be initiated by an Agency only in consultation with the other Agencies, if any, who participated in the coordinated examination process with respect to the banking entity that is the subject of the action.<sup>382</sup>

Under the Proposal, multiple regulators could be responsible for supervising, examining and enforcing the Proposal with respect to a trading desk or legal entity. For example, a national bank that is also both a CFTC-registered swap dealer and an SEC-registered security-based swap dealer (*e.g.*, if it enters into swaps on single loans) could be supervised by the OCC, CFTC and SEC. The problem is magnified for all banking entity families that, as allowed by the Proposal, institute enterprise-wide compliance regimes.<sup>383</sup>

This overlapping supervisory framework would undoubtedly lead to increased costs and harmful regulatory uncertainty. First, the duplication of supervisory responsibilities will necessarily increase costs to taxpayers. In fact, with the Agencies' resources already constrained, overlapping supervisory, examination and enforcement responsibilities may be largely unaffordable and therefore impracticable. Second, with five Agencies, and perhaps additional SROs, interpreting the Volcker Rule and its implementing regulations, there is a high potential for inconsistent, or worse, contradictory interpretations of the rule. At best, interpretations and guidance will be delayed while the Agencies consult and coordinate, freezing decision-making in the fast-moving trading environment. As a result, trading units could be left with the impracticable task of complying with the disparate positions of five or more regulators. This is particularly problematic because a single trading unit can span multiple legal entities, thereby invoking regulation by more than one Agency. Moreover, such uncertainty over how other Agencies might interpret the rule could lead an Agency to adopt overly conservative readings of the regulations, which would harm markets and the real economy.

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<sup>382</sup> The CFTC requested comment on supervisory coordination in Question 8.1 of its proposal.

<sup>383</sup> *See* Proposal, Appendix C § I.D.

We believe that a single Agency should have exclusive authority to interpret the Volcker Rule and the final Rule regulations. We believe this is necessary in light of the ability of banking entities to engage in enterprise-wide compliance as well as the possibility that trading units may span legal entities. While we believe that any of the Agencies might take on this task, we believe that the Board is the logical choice, as the Volcker Rule is a Bank Holding Company Act provision and the Board has traditionally interpreted that Act. We also believe such a role would be consistent with CFTC Chairman Gensler’s recent statement that the “CFTC’s role with regard to the Volcker Rule is significant, but it’s a supporting member along with the bank regulators who have the lead on bank holding companies” and SEC Chairman Schapiro’s statement that “I would imagine that we will rely heavily, as the CFTC will, on the Fed and the bank regulators to take the lead.”<sup>384</sup>

With respect to examinations and enforcement, we believe it is critical that there be one exam report per banking entity with one set of findings and one regulatory voice to the relevant banking entity. We believe such an arrangement would be consistent with the Agencies’ expressed desire to coordinate enforcement so as to avoid inconsistency and uncertainty. Thus we believe that, where more than one Agency has examination authority over a given banking entity, the appropriate Agencies should engage in a coordinated examination of such banking entity under the Volcker Rule. We believe that an Agency should be able to initiate an enforcement action under the Volcker Rule only in consultation with the other Agencies, if any, who participated in the coordinated examination process with respect to the banking entity that is the subject of the action.

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<sup>384</sup> *Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation: Joint Hearing Before H. Comm. on Fin. Servs.*, 112th Cong. (Jan. 18, 2012) (“**Joint Hearing**”) (Statements of CFTC Chairman Gary Gensler and SEC Chairman Mary Schapiro).

## XII. Phase-In and Effectiveness

### A. Statutory Conformance Period

**Recommendation:** Banking entities should have the full statutory conformance period to bring activities into compliance with the Volcker Rule. Banking entities should not be required to bring activities into compliance “as soon as practicable” after July 21, 2012.<sup>385</sup>

The statutory Volcker Rule includes a mandatory two-year conformance period from July 21, 2012 to July 21, 2014 and allows the Agencies to provide up to three one-year extensions.<sup>386</sup> Congress provided this conformance period to give banking entities a period of time during which to begin developing processes to apply the rules once they are finalized and interpretive questions are resolved. The Board incorporated this intent in its final conformance rule, which provided that banking entities will have two years from the effective date of the Volcker Rule in which to bring their existing proprietary trading activities into compliance.<sup>387</sup>

The Preamble to the Proposal does not accord with congressional intent in that it states that “[a] banking entity is expected to bring the prohibited proprietary trading activity of a trading unit into compliance with the requirements of the proposed rule *as soon as practicable* within the conformance period.”<sup>388</sup> This language is contrary to the congressional basis for providing a conformance period. Indeed, in the July 15, 2010 colloquy, Senator Merkley stated that the Volcker Rule was intended to proceed over a period of several years “[t]o provide markets and firms an opportunity to adjust.”<sup>389</sup> We note also that Federal Reserve Governor Daniel Tarullo, in the December 6, 2011 Senate Banking Committee Hearing on Dodd-Frank Implementation, stated that “the rule won’t take effect for another two and a half years.”<sup>390</sup>

As a result, we believe this language should be deleted and the Agencies should make clear that banking entities have the full two-year conformance period after release of a final rule to conform their activities. In addition to being inconsistent with the

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<sup>385</sup> We believe this section is responsive to Questions 1, 2 and 3 in the Proposal.

<sup>386</sup> See Bank Holding Company Act § 13(c)(2) (as added by Dodd-Frank § 619).

<sup>387</sup> See Conformance Rule § 225.181(a).

<sup>388</sup> Proposal at 68,855 (FRB 22) (emphasis added).

<sup>389</sup> See Statement of Senator Merkley, 156 Cong. Rec. S5898 (July 15, 2010).

<sup>390</sup> *Continued Oversight of the Implementation of the Wall Street Reform Act: Hearing Before the S. Banking Comm.*, 111th Cong. (Dec. 6, 2011) (Statement of Daniel Tarullo).

statutory conformance period, such language is inconsistent with the Board's final Conformance Rule. If the Agencies wish to amend the Board's Conformance Rule, the Administrative Procedure Act would require public notice and the opportunity for comment.

## B. Metrics and Compliance

**Recommendation:** Requiring banking entities to implement completely the metrics and compliance requirements by July 21, 2012 is inconsistent with the statutory Volcker Rule, is unrealistic and will be counterproductive.<sup>391</sup>

The Proposal requires banking entities to calculate required metrics and implement the required compliance program across all trading units by July 21, 2012.<sup>392</sup> This is at odds with the statutory provision, discussed above, that provides a two-year conformance period and allows the Agencies to grant three one-year extensions.

In addition, it is unrealistic that banking entities will be able to put in place the comprehensive compliance regime and calculate the quantitative metrics envisioned by the Proposal in the short period between issuance of the final rules and July 21, 2012. We believe that final rules are unlikely to be released until the late spring of 2012 at the earliest,<sup>393</sup> and that while some preparations can begin now the possibility of significant changes to the Proposal makes it impossible to fully plan for compliance at this point.<sup>394</sup>

The breadth of the compliance requirements will require banking entities to plan, develop and implement new systems, policies, procedures and compliance programs. Existing compliance structures will need to be reviewed and revised to comply with the final regulations. This will require looking at each trading unit individually to develop policies and procedures for its particular activities. This task is further complicated by the apparent worldwide application of the Volcker Rule, since markets and internal systems function differently and may therefore require significant updates and tailored approaches. As a result we believe that, once the rules are final, banking entities will need at least one year to implement their compliance programs.

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<sup>391</sup> We believe this section is responsive to Questions 2, 3, 144, 147 and 149.

<sup>392</sup> Proposal at 68,855 (FRB 22).

<sup>393</sup> The Agencies will receive a large number of comment letters on the Proposal. Given the complexity and significance of the Volcker Rule for the U.S. economy, we believe it is important that the Agencies devote sufficient time to thoughtfully and carefully consider these comments prior to adopting a final rule. We note that 1,378 comment letters were filed in advance of the FSOC Study in November 2010.

<sup>394</sup> This seems particularly likely in light of the fact that the Agencies have asked over 1,300 questions in the Proposal.

Banking entities subject to a metrics reporting requirement will also need significant time to implement such requirements. To comply with metrics reporting, banking entities will need to make significant changes to their technological infrastructure to be able to collect, aggregate, and process data, and then must test these new reporting systems. Requiring immediate full compliance would short circuit this productive iterative process.

Implementation of the metrics on July 21, 2012 also will be counterproductive, if not just impossible. The Agencies have suggested, and we agree, that the metrics should be implemented on an iterative basis that will likely result in metrics being modified or eliminated, and some additional metrics being required.<sup>395</sup> Additionally, as stated above, we believe the Agencies should use the statutory conformance period to begin collecting indicative metrics from banking entities to the extent banking entities are practically ready to produce them and inform themselves about differences in asset classes. This schedule will need to be set in conjunction with each individual banking entity and reflect the differences between banking entities.

We believe that the statutory two-year conformance period is the appropriate time for the Agencies to begin, though not complete, this task. During this time period, the Agencies can collect indicative metrics from banking entities on a voluntary basis.<sup>396</sup> In addition, we would suggest that the Agencies arrange a series of meetings with market participants, with the benefit of these indicative metrics, to discuss how appropriate metrics ranges may differ between asset classes, activities, trading units and firms. After the statutory conformance period is complete, the Agencies can use this knowledge to refine and begin reviewing reported quantitative metrics.

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<sup>395</sup> Proposal at 68,883 (FRB 83).

<sup>396</sup> As discussed above, *see* the discussion beginning on page A-119, during this iterative process it would be inappropriate to require that all banking entities report all contemplated metrics, in light of the significant changes to their technological infrastructure that will be necessary before banking entities will be able to report the new metrics.



## C. Phase-In

**Recommendation:** After the conformance period, the Volcker Rule regulations should be phased in. Final regulations should first apply to the U.S. activities of banking entities and only later to foreign activities of banking entities. Within each of these categories, the regulations should be phased in by asset class or line of business.<sup>397</sup>

We believe that the Agencies should phase in the prohibitions both by region and by asset class. Rather than attempt to enforce compliance on a global scale all at once, the Agencies should initially focus on trading activities in the United States. Within the United States, the Agencies should phase in compliance by asset class or line of business.<sup>398</sup> Over time, the Agencies would expand the compliance requirements to include other asset classes within the United States and, later, to include activities outside the United States.

This incremental, measured approach to implementation would comply with statutory mandates while mitigating disruption to the markets and the U.S. economy. It would also provide the Agencies with more time to analyze trading activities and develop more workable rules that accommodate the full spectrum of asset classes and markets.

In applying the Volcker Rule in stages, the Agencies would be following a trend of so doing for large regulatory-driven market changes. These include, for example, the introductions of TRACE reporting for corporate bonds and Regulations SHO and NMS in the equity markets. Regulation NMS was implemented through five separate, phased-in compliance dates for different stocks over a period of several years in order to allow the SEC and the industry to monitor for unintended consequences on the markets and for the SEC to revise the regulations as appropriate.<sup>399</sup> Indeed, just last month Federal Reserve Board Governor Daniel K. Tarullo and Acting FDIC Chairman Martin J. Gruenberg both stated in congressional testimony that they expected the Volcker Rule to be implemented through an

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<sup>397</sup> We believe this section is responsive to Questions 2 and 4.

<sup>398</sup> This approach would also permit banking agencies to implement the requirements of Title VII of the Dodd-Frank Act before conforming their swaps activities to the Volcker Rule. We strongly believe that the restrictions on proprietary trading in swaps, other than bright-line proprietary trading restrictions, should not be implemented until after final regulations under Title VII are effective.

<sup>399</sup> See Statement by SEC Chairman William H. Donaldson: Opening Statement at Commission Open Meeting of April 6, 2005, re: Regulation NMS, available at <http://www.sec.gov/news/speech/spch040605whd-nms.htm> (“The implementation will be staged to allow the Commission and the industry to watch for unforeseen problems before the rule applies to all stocks. As the roll-out progresses, the Commission will closely monitor whether the rule is having unintended consequences that give rise to a need to make modifications.”).

iterative process.<sup>400</sup> We strongly encourage such an approach. With respect to the Volcker Rule, the Agencies should place a premium on getting the rules right rather than implementing the Volcker Rule quickly.

We also believe that any entity that becomes or is acquired by a banking entity and, as a result, becomes subject to the final Volcker Rule regulations should have at least two years to conform their activities to the final regulations.<sup>401</sup> This is in line with the Bank Holding Company Act provisions that allow a bank holding company two years to bring the nonconforming activities of a newly acquired company into compliance with that Act. If no similar conformance period is provided here, a banking entity that acquires another firm would be in violation of the Volcker Rule immediately upon consummation of the transaction if the acquired entity engaged in any impermissible proprietary trading activities.

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<sup>400</sup> See Joint Hearing (Statement of Federal Reserve Board Governor Daniel K. Tarullo) (“the proposed rule, as you can tell, is informed by an expectation that there’s going to be an iterative quality to its implementation”); *id.* (Statement of Acting FDIC Chairman Martin J. Gruenberg) (“[T]here’s a two year compliance period provided by the statute for these companies to implement the rule, so in some sense it’ll be an extended period of engagement between the regulators and the companies.”).

<sup>401</sup> *Cf.* Bank Holding Company Act § 13(c)(2) (as added by Dodd-Frank § 619).

### XIII. Cost-Benefit Analysis

#### A. Need for Cost-Benefit Analysis

**Recommendation:** The Agencies should conduct a rigorous cost-benefit analysis of the Proposal consistent with the principles laid out in the *Business Roundtable* decision.<sup>402</sup>

As discussed throughout this comment letter, the Proposal would have a substantial impact on banking entities, their customers and the financial system as a whole. We believe that such a far-reaching impact warrants a thoughtful and complete cost-benefit analysis. In the Proposal, however, the Agencies have conducted a very limited analysis. We believe this is a fatal flaw that must be remedied by the Agencies. We further believe that, under a complete cost-benefit analysis, the Agencies would find that the costs of the Proposal far outweigh its benefits.

In finding that the SEC acted arbitrarily and capriciously in failing to “adequately assess the economic effects” of its new proxy access rule,<sup>403</sup> the *Business Roundtable* court articulated what we believe to be practices expected of all regulators in performing cost-benefit analyses. The *Business Roundtable* court found that an agency engaging in a cost-benefit analysis may not “inconsistently and opportunistically frame[] the costs and benefits” of a rule, “fail[] adequately to quantify the certain costs or to explain why those costs [cannot] be quantified,” “neglect[] to support its predictive judgments,” “contradict[] itself,” or “fail[] to respond to substantial problems raised by commenters.”<sup>404</sup> *Business Roundtable* also makes clear that agencies must explicitly consider every important problem posed by a rule.<sup>405</sup> After the comment period, therefore, the Agencies must consider and respond to comments raising concerns about and estimating the costs that will be imposed by the Volcker Rule.<sup>406</sup> Under this standard, agencies may not “duck[] serious evaluation of the costs that could be imposed.”<sup>407</sup>

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<sup>402</sup> We believe this section is responsive to Question 348 in the Proposal.

<sup>403</sup> *Business Roundtable*, 647 F.3d at 1148.

<sup>404</sup> *Id.* at 1148-49.

<sup>405</sup> *See id.* at 1151.

<sup>406</sup> *See id.* at 1152 (noting rule was arbitrary because SEC “failed to respond to comments” arguing use of rule by shareholders with special interests would impose costs).

<sup>407</sup> *Id.*

The Agencies are required to consider costs imposed by the Proposal under a variety of statutes, executive orders and agency policy statements. We believe that the limited cost-benefit analyses the Agencies have conducted have fallen far short of the statutory requirements and the *Business Roundtable* standards outlined above. In particular:

**The Regulatory Flexibility Act:** Under the Regulatory Flexibility Act (“RFA”), each of the Agencies must conduct a cost-benefit analysis of the effect on small entities unless the Proposal would not have a significant economic impact on a substantial number of small entities.<sup>408</sup> The Agencies claim that the Proposal would have no such impact, but provide no rigorous justification.<sup>409</sup> The Agencies’ assertion is incorrect because it fails to take account of the significant impact the Proposal will have on numerous small non-banking entities, by restricting their access to market-making and underwriting services. When these effects are taken into account, it is clear that the adverse effects on small entities are extensive and an RFA analysis is required.

A rule “regulates” small entities within the meaning of the RFA if it “directly affects” them, even if the regulation does not apply to those entities primarily or exclusively. For example, in *Aeronautical Repair Station Association, Inc. v. FAA*,<sup>410</sup> the FAA promulgated a regulation mandating that air carriers require drug and alcohol testing of employees.<sup>411</sup> The FAA argued that the RFA did not apply because the air carriers were not small entities. Although the regulation would affect small repair stations that contracted with air carriers to perform maintenance work, the FAA reasoned that an RFA analysis was unnecessary because those contractors were not “directly regulated” and were not the “targets” of the regulation.<sup>412</sup> The court rejected that argument, holding that the contractors were “subject to the proposed regulation” for purposes of the RFA even though the regulation was “immediately addressed” to the air carriers, because the regulations applied to employees of the contractors, just as it applied to employees of the air carriers.<sup>413</sup> The contractors were “directly affected and therefore regulated” within the meaning of the RFA.

Here, similarly, small entities will be “directly affected and therefore regulated,” even though they are not the express “targets” of the Proposal. The Proposal broadly restricts the provision of *services*, e.g., market making and underwriting. The activities of both the sellers (*i.e.*, banking entities, primarily) and the buyers (*i.e.*, large and small business entities) of those services are restricted by the Proposal. Countless small

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<sup>408</sup> See 5 U.S.C. § 601 *et seq.* The term “small entity” is defined as a “small business,” a “small organization,” or a “small governmental jurisdiction,” each of which is, in turn, defined.

<sup>409</sup> Proposal at 68,938-39 (FRB 204-05).

<sup>410</sup> 494 F.3d 161, 177 (D.C. Cir. 2007).

<sup>411</sup> *Id.* at 161.

<sup>412</sup> *Id.* at 175-76.

<sup>413</sup> *Id.* at 177.

entities will therefore have diminished access to the activities prohibited or heavily restricted by the rule. Although the Proposal enforces these restrictions by regulating only the sellers of those services, *i.e.*, banking entities, the effect, as in *Aeronautical Repair Station*, is to directly affect the small entities that are impeded by the impact of the rule from entering into transactions and receiving services that they otherwise would.

When these small entities are taken into account, it is clear that the Proposal has a “significant impact” on small entities. For example, the Proposal’s restrictions on market making and underwriting are severe and will reduce the availability and increase the costs of those services to small entities.

**Unfunded Mandates Act:** The OCC, as an executive agency, is required to conduct a thorough cost-benefit analysis of proposals under the Unfunded Mandates Reform Act of 1995 (“**Unfunded Mandates Act**”) unless it provides sufficient evidence that provisions other than those specifically set forth in the statute would not result in expenditures by state, local and tribal governments, or by the private sector, of \$100 million or more in any one year.<sup>414</sup> The OCC asserted in the Proposal that this threshold was not met without offering any evidence or articulating a rationale to support its conclusion,<sup>415</sup> although in a memorandum dated September 7, 2011, the OCC shed a little more light on its thinking. In the memorandum, it estimated that the Proposal (without the dollar-for-dollar capital deduction for banks with investments in covered funds) would impose compliance costs of approximately \$50 million annually.<sup>416</sup> The OCC explains it focused its analysis upon the impact of compliance and reporting requirements because under the Unfunded Mandates Act, it need not consider the cost of mandates required by statute. As we explain in further detail below, however, many of the Proposal’s costs result not from the statute but from discretionary policy positions adopted by the Agencies. Accordingly, the OCC was obligated to expand the scope of its analysis beyond mere compliance costs and estimate the annual costs imposed by the many discretionary policy choices in the Proposal. If the OCC had conducted a proper analysis, we believe it would have found the costs of the Proposal far exceed the Unfunded Mandates Act threshold, as the compliance program set forth would, on its own, exceed \$100 million and the costs to the economy would be even greater. Accordingly, we believe the OCC’s determination was clearly arbitrary and capricious.

**Small Business Act:** All of the Agencies are required to perform a cost-benefit analysis under the Small Business Regulatory Enforcement Fairness Act of 1996 (“**Small Business Act**”), unless they demonstrate that the Proposal will not result in (i) an annual

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<sup>414</sup> See 2 U.S.C. § 1532.

<sup>415</sup> See Proposal at 68,939 (FRB 205).

<sup>416</sup> The OCC in its memorandum also estimated the cost of dollar-for-dollar capital reduction for banks with investments in covered funds would be approximately \$917 million annually, but there is no mention of any such cost, which clearly exceeds \$100 million, in the Proposal.

effect on the U.S. economy of \$100 million or more, (ii) a major increase in the costs or prices for consumers or individual industries, or (iii) significant adverse effects on competition, investment, or innovation.<sup>417</sup> The Agencies have shifted this burden to the public by requesting comment on the economic effect.<sup>418</sup> The Agencies must affirmatively reach a conclusion on that threshold economic impact issue and provide sufficient evidence to support that conclusion in order to satisfy the standard established in the *Business Roundtable* decision.

**Securities Exchange Act of 1934:** As the SEC acknowledges in the Proposal,<sup>419</sup> it is required to analyze the effect of the Proposal’s compliance and enforcement provisions on registered broker-dealers and security-based swap dealers under Sections 3(f) and 23(a)(2) of the Securities Exchange Act of 1934 (“**Exchange Act**”).<sup>420</sup> The SEC’s responsibility is “to determine as best it can the economic implications of the rule it has proposed.”<sup>421</sup> In addition, that analysis must be made available for public comment during the rulemaking.<sup>422</sup>

The limited analysis that exists in the Proposal falls far short of these requirements. The Preamble fails to provide any estimate at all of the costs of the recordkeeping and documentation requirements. Previous SEC rules have been invalidated for comparable deficiencies. In *Chamber I*, the SEC declined to estimate certain regulatory costs because it said it did not know the means that mutual funds would use to satisfy its rule. In remanding, the D.C. Circuit responded: “That particular difficulty may mean that the Commission can determine only the range within which a fund’s cost of compliance will fall . . . but . . . it does not excuse the Commission from its statutory obligation to determine as best it can the economic implications of the rule it has proposed.”<sup>423</sup> More recently, in *Business Roundtable v. SEC*,<sup>424</sup> the D.C. Circuit vacated a SEC regulation in part because the

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<sup>417</sup> Pub. L. 104-121, Title II, 110 Stat. 857 (1996).

<sup>418</sup> See Proposal at 68,939 (FRB 206); *Business Roundtable*, 647 F.3d at 1152 (Agencies may not “duck[] serious evaluation of the costs that could be imposed” by a rule).

<sup>419</sup> See Proposal at 68,940 (FRB 209).

<sup>420</sup> 15 U.S.C. § 78c(f) (“Whenever pursuant to this chapter, the Commission is engaged in rulemaking, the Commission must consider . . . whether the action will promote efficiency, competition, and capital formation.”); 15 U.S.C. § 78w(a)(2) (“The Commission . . . shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of” the Exchange Act.). The SEC’s analysis is limited in this way because it relied on the Exchange Act for authority to issue only those portions of the Proposal.

<sup>421</sup> *Chamber of Commerce v. SEC (Chamber I)*, 412 F.3d 133, 143 (D.C. Cir. 2005).

<sup>422</sup> See *Chamber of Commerce v. SEC (Chamber II)*, 443 F.3d 890, 905 (D.C. Cir. 2006) (public was entitled to notice of and an opportunity to comment on materials that were significant to agency’s analysis).

<sup>423</sup> 412 F.3d at 143.

<sup>424</sup> 647 F.3d 1144 (D.C. Cir. 2011).

SEC “did nothing to estimate and quantify the costs” it expected companies to incur under that regulation.<sup>425</sup>

The Proposal also engages in inconclusive speculation rather than providing the well-grounded predictions and estimates required for reasoned rulemaking. For example, the Proposal speculates that these requirements “*may* marginally reduce the ability of covered banking entities . . . to compete,” “*may* lead to a decreased competitiveness,” “*may*” cause banking entities to “reduce the size or scope of their market-making activities,” and “could likewise harm efficiency and capital formation.”<sup>426</sup> Indeed, these things *will* occur and, in any event, it is the Agencies’ obligation to make their best projection of what will happen and the magnitude of the effect. It is insufficient to muse about what “*may*”—and by implication “*may not*”—result from the Agencies’ action.

Similarly, the SEC did not list any benefits that could justify the negative effects of the Proposal on efficiency, competition, and capital formation. As a result, we believe that the SEC has not met its statutory duty, as clarified in the *Business Roundtable* case, to conduct an Exchange Act cost-benefit analysis.

**Commodity Exchange Act:** The CFTC is subject to a cost-benefit mandate similar to the SEC’s under Section 15(a) of the Commodity Exchange Act (“**CEA**”) to the extent it issues any portion of its rules under the CEA.<sup>427</sup>

**Executive Orders:** The Agencies are all subject to executive orders requiring cost-benefit analyses.<sup>428</sup> Although the order applicable to independent agencies is not by its terms binding, each of the Agencies has announced its intention to comply with the principles contained in the order as a matter of policy.<sup>429</sup> As a result, we believe these Agencies are

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<sup>425</sup> *Id.* at 1150.

<sup>426</sup> Proposal at 68,941-42 (FRB 210-11) (emphasis added).

<sup>427</sup> 7 U.S.C. § 19(a) (“Before promulgating a regulation under this chapter . . . the Commission shall consider the costs and benefits of the action of the Commission . . . in light of . . . considerations of the efficiency, competitiveness, and financial integrity of futures markets.”).

<sup>428</sup> See Executive Order No. 13,579, 76 Fed. Reg. 41,587 (July 14, 2011), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2011-07-14/pdf/2011-17953.pdf> (urging independent agencies to comply with the cost-benefit mandates in the executive orders applicable to executive agencies); Executive Order No. 13,563, 76 Fed. Reg. 3,821 (Jan. 21, 2011), *available at* <http://www.whitehouse.gov/the-press-office/2011/01/18/improving-regulation-and-regulatory-review-executive-order> (requiring all executive agencies to perform a thorough cost-benefit analysis of all rules); Executive Order No. 12,688, 58 Fed. Reg. 51,735 (Sept. 30, 1993), *available at* [http://www.reginfo.gov/public/jsp/Utilities/EO\\_12866.pdf](http://www.reginfo.gov/public/jsp/Utilities/EO_12866.pdf); Office of Management & Budget, Executive Office of the President, OMB Circular No. A-4, Regulatory Analysis (2003), *available at* <http://www.whitehouse.gov/sites/default/files/omb/assets/omb/circulars/a004/a-4.pdf>.

<sup>429</sup> See CFTC, Reducing Regulatory Burden; Retrospective Review Under E.O. 13563, 76 Fed. Reg. 38,328, 38,328 (June 30, 2011), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2011-06-30/pdf/2011-16430.pdf> (“In accordance with Executive Order 13563, . . . the [CFTC] intends to review its existing regulations to evaluate their continued effectiveness in achieving the objectives for which they were adopted. . . . The . . . continued)

required to perform the sort of thorough cost-benefit analysis of the Proposal contemplated by that executive order unless and until their policies to comply with that order are publicly revoked. In addition to the statutory mandates discussed above, the OCC is also required to conduct a thorough cost-benefit analysis under a number of executive orders binding on executive agencies.<sup>430</sup> The OCC has not complied with those executive orders because it has failed to perform the required cost-benefit analysis of the Proposal.<sup>431</sup>

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(continued...)

Executive Order emphasizes several guiding principles, including that: agencies consider the costs and benefits of their regulations and choose the least burdensome path.”); FDIC’s Plans to Review Existing Regulations for Continued Effectiveness (Nov. 10, 2011), *available at* <http://www.fdic.gov/regulations/laws/plans/index.html> (responding to Executive Order 13579 by describing the FDIC’s “longstanding policy of implementing its regulations in the least-burdensome manner possible.”); FDIC Statement of Policy on the Development and Review of FDIC Regulations and Policies, 63 Fed. Reg. 25,157, 25,158 (1998) (“Burdens imposed on the banking industry and the public should be minimized.”); Letter from Fed Chairman Ben Bernanke to Mr. Cass Sunstein, OMB, pp 1, 4 (Nov. 8, 2011), *available at* <http://www.federalreserve.gov/generalinfo/foia/regulatory-burden-reduction-111115.pdf> (“[W]e at the Federal Reserve have . . . for many years tried to abide by the principles described in the Executive Order. . . . The Federal Reserve is committed to adopting rules and policies that are effective in implementing its statutory responsibilities and the intent of Congress without imposing unnecessary costs.”); SEC, Retrospective Review of Existing Regulations, 76 Fed. Reg. 56,128 (Sept. 12, 2011), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2011-09-12/pdf/2011-23179.pdf> (inviting public comment on how the SEC can develop a plan to comply with Executive Order 13579).

<sup>430</sup> *See, e.g.*, Executive Order No. 13563, 76 Fed. Reg. 3821 (Jan. 21, 2011), *available at* <http://www.whitehouse.gov/the-press-office/2011/01/18/improving-regulation-and-regulatory-review-executive-order> (requiring all executive agencies to perform a thorough cost-benefit analysis of all rules); Executive Order No. 12,688, 58 Fed. Reg. 51,735 (Sept. 30, 1993), *available at* [http://www.reginfo.gov/public/jsp/Utilities/EO\\_12866.pdf](http://www.reginfo.gov/public/jsp/Utilities/EO_12866.pdf); Office of Management & Budget, Executive Office of the President, OMB Circular No. A-4, Regulatory Analysis (2003), *available at* <http://www.whitehouse.gov/sites/default/files/omb/assets/omb/circulars/a004/a-4.pdf>.

<sup>431</sup> If certain pending legislation—in particular the Financial Regulatory Responsibility Act of 2011—becomes law, the Agencies could become subject to a new cost-benefit mandate retroactively. *See, e.g.*, Financial Regulatory Responsibility Act of 2011, S. 1615, 112th Cong., 2nd Sess. (2011), *available at* <http://www.gpo.gov/fdsys/pkg/BILLS-112s1615is/pdf/BILLS-112s1615is.pdf> (requiring all federal financial agencies to perform a rigorous cost-benefit analysis of all rules implementing federal financial statutes, as well as a retroactive cost-benefit analysis of pre-existing regulations).



## B. Costs Outweigh Benefits

**Recommendation:** If the Agencies perform the sort of cost-benefit analysis contemplated in the *Business Roundtable* decision, we believe they will find that the costs of the Proposal substantially outweigh the benefits.<sup>432</sup>

If the Agencies perform the sort of cost-benefit analysis contemplated in the *Business Roundtable* decision, we believe they will find that the costs of many of the policy choices made in the Proposal substantially outweigh the benefits.

In particular, we believe that the costs of narrowly construing the market making-related, underwriting and risk-mitigating hedging permitted activities will be substantial. We believe the marginal benefit of trying to screen every permitted activity in search of possible prohibited proprietary trading in this way is minimal and is far outweighed by the cost. As has been demonstrated in the Oliver Wyman study, a narrow view of market making will have a dramatic impact on liquidity, asset values and transaction costs for issuers and investors. Specifically, the study, which analyzed the effect of the Volcker Rule on the U.S. corporate bond market, concluded that the proposed rigid implementation would reduce liquidity, costing investors \$90 to \$315 billion in mark-to-market loss of value and \$1 to \$4 billion in annual transaction costs, and costing corporate issuers \$12 to \$43 billion per year in borrowing costs.<sup>433</sup> The same point has been made by asset managers and in letters by members of Congress. And yet, nowhere does the Proposal analyze or weigh the costs and benefits of policy choices that are within the discretion of the Agencies.

We believe that many of the costs of the Proposal result not from the statute, but from the discretionary positions adopted by the Agencies in the Proposal. For example, the Proposal (but not the statute) requires market makers to “generate revenues primarily from fees, commissions, [and] bid-ask spreads,” and not from price appreciation of retained positions or hedging profits. As we discuss above,<sup>434</sup> this distinction falls apart in less liquid markets where, among other things, market makers often need to hold inventory, making it difficult to distinguish between revenues from bid-ask spreads and revenues from price appreciation.<sup>435</sup> Because the Proposal may hinder market makers’ ability to manage their

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<sup>432</sup> We believe this section is responsive to Questions 357 and 358 in the Proposal.

<sup>433</sup> Oliver Wyman 2012 Study at 2 (2011); *see also* Letter from AllianceBernstein LP to the Agencies (Nov. 16, 2011) (estimating Proposal will create annual costs of \$41 billion for U.S. corporate bond market, excluding indirect costs and adverse economic impact).

<sup>434</sup> *See* the discussion beginning on page A-30.

<sup>435</sup> In the fixed income business, bid-ask spreads have largely diminished and market makers instead earn revenues from movements in the prices of the bonds that result from changes in counterparty, interest rate, (...continued)

inventories by forcing them to unload their positions too rapidly, it will decrease liquidity and inevitably lead to higher fees for customers.<sup>436</sup> In the extreme, banking entities will be unable to intermediate as principal in these markets entirely. We see no indication in the Proposal that the Agencies have taken this into account, nor have the Agencies attempted to quantify the marginal benefit of this approach over and above the metrics-based approach we suggest above.<sup>437</sup>

The Proposal also requires that any hedging transaction be “reasonably correlated . . . to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate.”<sup>438</sup> The Preamble to the rule adds that “risks that can be easily and cost-effectively hedged with extremely high or near-perfect correlation would typically be expected to be so hedged.”<sup>439</sup> As we discuss above,<sup>440</sup> it is critical that trading units have discretion to construct appropriate hedges; under the Proposal, however, trading units will face uncertainty as to whether their hedges are in fact “reasonably correlated” or whether a hedge has an “extremely high” correlation to a given risk. The Agencies’ interpretation of the statutory risk-mitigating hedging permitted activity, therefore, could chill the use of *bona fide* risk-mitigating hedging activities, as trading units will fear ex-post investigation of even their permissible hedges. The rule could thus hamper the ability of banking entities to engage in effective risk management, which would impose significant costs on the financial system and the economy. The benefit of a rigid rule, however, is far from clear. We think the Agencies have improperly neglected to consider whether there is any economic justification for a rigid provision.

As another example, we believe that choosing not to permit proprietary trading in derivatives on permitted government obligations could significantly reduce liquidity in the markets for Treasuries, Agency securities and other government obligations, with little benefit. Similarly, excluding state and municipal agency and authority obligations would reduce liquidity in these markets and increase financing costs for state and local governments, again with little benefit. As it is within the Agencies’ discretion to exempt these trading activities, they are responsible for considering the economic impact of choosing not to do so.

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(continued...)

and other risks. See Bernstein Research, *Quick Take — U.S. Brokerage: Draft Volcker Rules Threaten Fixed Income*, at (2011).

<sup>436</sup> See, e.g., Letter from U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, at 7 (Dec. 15, 2011) (estimating Proposal will increase bid-ask spreads from 5 to as many as 100 basis points).

<sup>437</sup> See the discussions beginning on pages A-23 and A-62.

<sup>438</sup> Proposal § \_\_.5(b)(2)(iii).

<sup>439</sup> Proposal at 68,875 (FRB 66).

<sup>440</sup> See the discussion beginning on page A-66.

We believe the Agencies have also failed to consider secondary costs that could be imposed by the Proposal's apparent narrow construction of the permitted activities. For example, as we discuss above, the Proposal's apparent narrow interpretation of market making-related permitted activities could significantly reduce liquidity in the market, causing obvious first order effects such as increased transaction costs. A reduction in liquidity, however, will also indirectly impair capital formation, because investors will be less willing to purchase new issuances if they believe they will have difficulty selling those investments in a less liquid secondary market. It is imperative that the Agencies consider these kinds of secondary effects that, although less obvious, could impose huge costs on financial markets and the economy.

### C. Reproposal

**Recommendation:** The Agencies should repropose the rule once they have conducted a meaningful cost-benefit analysis.

The Agencies' current economic assessment is so flawed that they may not finalize the rule without first reproposing it for public comment with a proper economic analysis.<sup>441</sup> A failure to do so would constitute a repeat of the *Chamber II* litigation. In that case, the SEC readopted a rule relying on a handful of materials that had not been exposed to public comment. The SEC argued that reproposal was unnecessary because the new materials merely confirmed the agency's initial analysis. The court, finding that additional notice and comment was required, vacated the rule.<sup>442</sup>

As in *Chamber II*, the Agencies have provided no analysis of costs and benefits that would result from the proposed regulations, instead asking commenters to provide such analysis.<sup>443</sup> The Agencies must now either develop a more robust economic

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<sup>441</sup> See the discussion beginning on page 6.

<sup>442</sup> *Chamber II*, 443 F.3d at 903-05; see also *Engine Mfrs. Ass'n v. EPA*, 20 F.3d 1177, 1182 (D.C. Cir. 1994) (invalidating rule because published materials were too "opaque" and "[t]here [was] no way to know the agency's methodology from what little it reveal[ed] in the cost analysis"); *Prometheus Radio Project v. FCC*, 652 F.3d 431, 447-53 (3d Cir. 2011) (vacating and remanding an FCC rule because the FCC released "several additional peer review comments, 'revised' versions of four of the studies, and new peer review studies" on the last day for comments).

<sup>443</sup> See, e.g., Proposal at 68,870 (FRB 55) (asking for comments on the costs and benefits of proposed market-making definition without providing any indication of the agencies' views); *id.* at 68,926 (FRB 177) ("We seek comment on whether, in order to comply with the statutory prohibition on proprietary trading, some banking entities may be inclined to abstain from some market-making activities [and] this could result in reduced liquidity for certain types of trades or for certain less liquid instruments."); Joint Hearing at 46-47 (Chairman Schapiro and Mr. Turner, in response to question by Rep. Gutierrez, asserting that agencies have requested commenters to provide pertinent economic analysis).

analysis on their own, or through materials provided by commenters. Either method requires reproposal.<sup>444</sup>

Of course, in the process of drafting the final rule as well, the Agencies must “respond to substantial problems raised by commenters.”<sup>445</sup> We believe that we, as well as many other commenters, have raised many such substantial concerns and have offered solutions that the Agencies should consider. We look forward to opportunities to discuss our proposed solutions with the Agencies as they continue to move forward in this important rulemaking.

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<sup>444</sup> See *Portland Cement Ass’n v. Ruckelshaus*, 486 F.2d 375, 393 (D.C. Cir. 1973).

<sup>445</sup> *Business Roundtable*, 647 F.3d at 1149.

## Table of Questions to Which Statements Respond

The numbers in the “Page in Letter” column are hyperlinks to the appropriate section of the letter.

| Question in Proposal                                  | Statement   | Page in Letter | Rule Section       | Statutory Section |
|---|---|----------------|--------------------|-------------------|
| <b>Covered Financial Position and Trading Account</b> |   |                |                    |                   |
| Question 14<br>(Page 35)                              | The proposed definition of “trading account” exceeds statutory authority and should be limited to the purpose test.   | A-12           | § __.3(b)(2)(i)    | § 13(h)(6)        |
|   | The “trading account” definition, and the Proposal more generally, should be changed to remove implicit negative presumptions.  | A-13           | § __.3(b)(2)(i)    | § 13(h)(6)        |
|   | The Agencies should eliminate the “Market Risk Capital Rule test” or, in the alternative, treat it as a nonexclusive indicative factor rather than as a dispositive test. | A-16           | § __.3(b)(2)(i)(B) | § 13(h)(6)        |
|   | The Agencies should eliminate the “status test” or, at most, treat the status test as a nonexclusive indicative factor rather than as a dispositive test.                 | A-18           | § __.3(b)(2)(i)(C) | § 13(h)(6)        |
| Question 15<br>(Page 35)                              | The Agencies should eliminate the “Market Risk Capital Rule test” or, in the alternative, treat it as a nonexclusive indicative factor rather than as a dispositive test. | A-16           | § __.3(b)(2)(i)(B) | § 13(h)(6)        |
| Question 16<br>(Page 35)                              | The Agencies should eliminate the “Market Risk Capital Rule test” or, in the alternative, treat it as a nonexclusive indicative factor rather than as a dispositive test. | A-16           | § __.3(b)(2)(i)(B) | § 13(h)(6)        |
| Question 17<br>(Page 35)                              | The Agencies should refashion the sixty-day holding period presumption and include it as guidance rather than as a hard-coded rule.                                       | A-19           | § __.3(b)(2)(ii)   | § 13(h)(6)        |
| Question 19<br>(Pages 35-36)                          | Daily variation margin should not be viewed as an indicator of short-term proprietary trading intent.   | A-20           | § __.3(b)(2)(i)(A) | § 13(h)(6)        |

| Question in Proposal     | Statement   | Page in Letter | Rule Section       | Statutory Section |
|--------------------------|---|----------------|--------------------|-------------------|
| Question 22<br>(Page 36) | The Agencies should eliminate the “status test” or, at most, treat the status test as a nonexclusive indicative factor rather than as a dispositive test.   | A-18           | § __.3(b)(2)(i)(C) | § 13(h)(6)        |
| Question 23<br>(Page 36) | The Agencies should refashion the sixty-day holding period presumption and include it as guidance rather than as a hard-coded rule.   | A-19           | § __.3(b)(2)(ii)   | § 13(h)(6)        |
| Question 26<br>(Page 36) | The Agencies should refashion the sixty-day holding period presumption and include it as guidance rather than as a hard-coded rule.   | A-19           | § __.3(b)(2)(ii)   | § 13(h)(6)        |
| Question 27<br>(Page 36) | The Agencies should refashion the sixty-day holding period presumption and include it as guidance rather than as a hard-coded rule.   | A-19           | § __.3(b)(2)(ii)   | § 13(h)(6)        |
| Question 46<br>(Page 42) | The Agencies should narrow the definition of “derivative” to avoid including in the “covered financial position” definition instruments that should not be part of the Volcker Rule proprietary trading restrictions. | A-14           | § __.3(b)(3)(i)(B) | § 13(h)(6)        |
| Question 47<br>(Page 42) | The Agencies should narrow the definition of “derivative” to avoid including in the “covered financial position” definition instruments that should not be part of the Volcker Rule proprietary trading restrictions. | A-14           | § __.3(b)(3)(i)(B) | § 13(h)(6)        |
| Question 48<br>(Page 42) | The Agencies should narrow the definition of “derivative” to avoid including in the “covered financial position” definition instruments that should not be part of the Volcker Rule proprietary trading restrictions. | A-14           | § __.3(b)(3)(i)(B) | § 13(h)(6)        |
| Question 54<br>(Page 45) | The Agencies should narrow the definition of “derivative” to avoid including in the “covered financial position” definition instruments that should not be part of the Volcker Rule proprietary trading restrictions. | A-14           | § __.3(b)(3)(i)(B) | § 13(h)(6)        |

| Question in Proposal                            | Statement  | Page in Letter | Rule Section    | Statutory Section |
|---|--|----------------|-----------------|-------------------|
| <b>Market Making-Related Permitted Activity</b> |  |                |                 |                   |
| Question 80<br>(Page 54)                        | The Agencies' approach to the market making-related permitted activity would have significant deleterious real-world effects on the financial markets and on the investors and customers that rely on such markets for liquidity.  | A-22           | § __.4(b)       | § 13(d)(1)(B)     |
|   | The Agencies' approach to market making should be replaced by one in which trading units are allowed to engage in customer-focused market making-related activities.   | A-23           | § __.4(b)       | § 13(d)(1)(B)     |
|   | The hard-coded factors in the Proposal's rule should be removed from the rule itself and become principles-based guidance for reasonably designed policies and procedures. The Agencies should receive information from quantitative metrics, policies and procedures and examinations to oversee the system.  | A-24           | § __.4(b)       | § 13(d)(1)(B)     |
|   | In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in <i>any</i> market, even the most liquid equity markets.  | A-26           | § __.4(b)       | § 13(d)(1)(B)     |
|   | The hard-coded set of criteria appears to reduce the permitted activity to "market making," rather than "market making-related," activity, contrary to congressional intent.   | A-29           | § __.4(b)       | § 13(d)(1)(B)     |
|   | The Agencies should not require, even in guidance, that market making-related permitted activities be "designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income." This formulation exceeds statutory intent, prejudices appropriate results for revenue metrics and ignores the fact that, frequently, a <i>bona fide</i> market maker may not be able to provide market making services unless it can benefit from revenues from market movements. | A-30           | § __.4(b)(2)(v) | § 13(d)(1)(B)     |

| Question in Proposal  | Statement   | Page in Letter | Rule Section      | Statutory Section |
|-----------------------|---|----------------|-------------------|-------------------|
|                       | The Agencies should not analyze the market making-related permitted activity on a transaction-by-transaction basis.   | A-34           | §§ __.4(b)(1)-(2) | § 13(d)(1)(B)     |
|                       | The regulations implementing the market making-related permitted activity should reflect the role of market makers as intermediaries between market participants in different physical locations, at different times and in different sizes.  | A-36           | § __.4(b)         | § 13(d)(1)(B)     |
|                       | The Proposal’s discussion of what constitutes a market maker “hold[ing] itself out as being willing to buy and sell . . . on a regular or continuous basis” is too narrow to reflect market making in the vast majority of markets  | A-37           | § __.4(b)(2)(ii)  | § 13(d)(1)(B)     |
|                       | The proposed guidance around the “reasonably expected near term demands of clients, customers or counterparties” requirement misconstrues the statutory requirement and does not adequately allow market makers to build and maintain necessary inventory.  | A-41           | § __.4(b)(2)(iii) | § 13(d)(1)(B)     |
|                       | The Agencies should expressly include interdealer market making-related activities within the permitted activity.   | A-44           | § __.4(b)         | § 13(d)(1)(B)     |
|                       | The Agencies should remove the requirement that a market maker be registered as a dealer or subject to substantive regulation.  | A-47           | § __.4(b)(2)(iv)  | § 13(d)(1)(B)     |
| Question 81 (Page 54) | The Agencies’ approach to market making should be replaced by one in which trading units are allowed to engage in customer-focused market making-related activities.  | A-23           | § __.4(b)         | § 13(d)(1)(B)     |
|                       | The hard-coded factors in the Proposal’s rule should be removed from the rule itself and become principles-based guidance for reasonably designed policies and procedures. The Agencies should receive information from quantitative metrics, policies and procedures and examinations to oversee the system. | A-24           | § __.4(b)         | § 13(d)(1)(B)     |



| Question in Proposal | Statement  | Page in Letter | Rule Section      | Statutory Section |
|----------------------|--|----------------|-------------------|-------------------|
|                      | In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in <i>any</i> market, even the most liquid equity markets.  | A-26           | § __.4(b)         | § 13(d)(1)(B)     |
|                      | The Agencies should not require, even in guidance, that market making-related permitted activities be “designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income.” This formulation exceeds statutory intent, prejudices appropriate results for revenue metrics and ignores the fact that, frequently, a <i>bona fide</i> market maker may not be able to provide market making services unless it can benefit from revenues from market movements. | A-30           | § __.4(b)(2)(v)   | § 13(d)(1)(B)     |
|                      | The Agencies should not analyze the market making-related permitted activity on a transaction-by-transaction basis.  | A-34           | §§ __.4(b)(1)-(2) | § 13(d)(1)(B)     |
|                      | The regulations implementing the market making-related permitted activity should reflect the role of market makers as intermediaries between market participants in different physical locations, at different times and in different sizes.   | A-36           | § __.4(b)         | § 13(d)(1)(B)     |
|                      | The Proposal’s discussion of what constitutes a market maker “hold[ing] itself out as being willing to buy and sell . . . on a regular or continuous basis” is too narrow to reflect market making in the vast majority of markets   | A-37           | § __.4(b)(2)(ii)  | § 13(d)(1)(B)     |
|                      | The proposed guidance around the “reasonably expected near term demands of clients, customers or counterparties” requirement misconstrues the statutory requirement and does not adequately allow market makers to build and maintain necessary inventory.   | A-41           | § __.4(b)(2)(iii) | § 13(d)(1)(B)     |

| Question in Proposal  | Statement  | Page in Letter | Rule Section     | Statutory Section |
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|                       | The Agencies should remove the requirement that a market maker be registered as a dealer or subject to substantive regulation.   | A-47           | § __.4(b)(2)(iv) | § 13(d)(1)(B)     |
| Question 82 (Page 55) | The interpretation of “block positioner” should be expanded to address the differences between asset classes.  | A-40           | § __.4(b)        | § 13(d)(1)(B)     |
| Question 83 (Page 55) | The Agencies’ approach to the market making-related permitted activity would have significant deleterious real-world effects on the financial markets and on the investors and customers that rely on such markets for liquidity.                  | A-22           | § __.4(b)        | § 13(d)(1)(B)     |
| Question 84 (Page 55) | The Agencies’ approach to the market making-related permitted activity would have significant deleterious real-world effects on the financial markets and on the investors and customers that rely on such markets for liquidity.                  | A-22           | § __.4(b)        | § 13(d)(1)(B)     |
| Question 85 (Page 55) | The interpretation of “block positioner” should be expanded to address the differences between asset classes.  | A-40           | § __.4(b)        | § 13(d)(1)(B)     |
|                       | If foreign sovereign debt is not excluded from the Volcker Rule restrictions, the Agencies must ensure that operations of banking entities in foreign jurisdictions are allowed to meet that jurisdiction’s primary dealer and other requirements. | A-51           | § __.4(b)        | § 13(d)(1)(B)     |
|                       | The Agencies should clarify that banking entities can make markets in, and be Authorized Participants for, exchange-traded funds.  | A-51           | § __.4(b)        | § 13(d)(1)(B)     |
| Question 86 (Page 55) | The interpretation of “block positioner” should be expanded to address the differences between asset classes.  | A-40           | § __.4(b)        | § 13(d)(1)(B)     |

| Question in Proposal     | Statement   | Page in Letter | Rule Section | Statutory Section |
|--------------------------|---|----------------|--------------|-------------------|
|                          | The Agencies should expressly include interdealer market making-related activities within the permitted activity.   | A-44           | § __.4(b)    | § 13(d)(1)(B)     |
|                          | The Agencies should ensure that banking entities can be market makers in new or bespoke products, including structured products and transactions driven by customer requests.   | A-46           | § __.4(b)    | § 13(d)(1)(B)     |
|                          | The market making-related permitted activity should recognize that arbitrage activities, as the Agencies understand them, can constitute market making-related activities.  | A-49           | § __.4(b)    | § 13(d)(1)(B)     |
|                          | If foreign sovereign debt is not excluded from the Volcker Rule restrictions, the Agencies must ensure that operations of banking entities in foreign jurisdictions are allowed to meet that jurisdiction’s primary dealer and other requirements.  | A-51           | § __.4(b)    | § 13(d)(1)(B)     |
|                          | The Agencies should clarify that banking entities can make markets in, and be Authorized Participants for, exchange-traded funds.   | A-51           | § __.4(b)    | § 13(d)(1)(B)     |
| Question 87<br>(Page 62) | The Agencies’ approach to market making should be replaced by one in which trading units are allowed to engage in customer-focused market making-related activities.  | A-23           | § __.4(b)    | § 13(d)(1)(B)     |
|                          | The hard-coded factors in the Proposal’s rule should be removed from the rule itself and become principles-based guidance for reasonably designed policies and procedures. The Agencies should receive information from quantitative metrics, policies and procedures and examinations to oversee the system. | A-24           | § __.4(b)    | § 13(d)(1)(B)     |

| Question in Proposal  | Statement  | Page in Letter | Rule Section      | Statutory Section |
|-----------------------|--|----------------|-------------------|-------------------|
|                       | In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in <i>any</i> market, even the most liquid equity markets.  | A-26           | § __.4(b)         | § 13(d)(1)(B)     |
|                       | The hard-coded set of criteria appears to reduce the permitted activity to “market making,” rather than “market making-related,” activity, contrary to congressional intent.   | A-29           | § __.4(b)         | § 13(d)(1)(B)     |
|                       | The Agencies should not require, even in guidance, that market making-related permitted activities be “designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income.” This formulation exceeds statutory intent, prejudices appropriate results for revenue metrics and ignores the fact that, frequently, a <i>bona fide</i> market maker may not be able to provide market making services unless it can benefit from revenues from market movements. | A-30           | § __.4(b)(2)(v)   | § 13(d)(1)(B)     |
|                       | The Proposal’s discussion of what constitutes a market maker “hold[ing] itself out as being willing to buy and sell . . . on a regular or continuous basis” is too narrow to reflect market making in the vast majority of markets   | A-37           | § __.4(b)(2)(ii)  | § 13(d)(1)(B)     |
|                       | The proposed guidance around the “reasonably expected near term demands of clients, customers or counterparties” requirement misconstrues the statutory requirement and does not adequately allow market makers to build and maintain necessary inventory.   | A-41           | § __.4(b)(2)(iii) | § 13(d)(1)(B)     |
| Question 88 (Page 62) | In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in <i>any</i> market, even the most liquid equity markets.  | A-26           | § __.4(b)         | § 13(d)(1)(B)     |

| Question in Proposal     | Statement  | Page in Letter | Rule Section     | Statutory Section |
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|                          | The Proposal’s discussion of what constitutes a market maker “hold[ing] itself out as being willing to buy and sell . . . on a regular or continuous basis” is too narrow to reflect market making in the vast majority of markets           | A-37           | § __.4(b)(2)(ii) | § 13(d)(1)(B)     |
| Question 89<br>(Page 62) | In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in <i>any</i> market, even the most liquid equity markets.            | A-26           | § __.4(b)        | § 13(d)(1)(B)     |
|                          | The hard-coded set of criteria appears to reduce the permitted activity to “market making,” rather than “market making-related,” activity, contrary to congressional intent.   | A-29           | § __.4(b)        | § 13(d)(1)(B)     |
| Question 90<br>(Page 62) | In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in <i>any</i> market, even the most liquid equity markets.            | A-26           | § __.4(b)        | § 13(d)(1)(B)     |
|                          | The regulations implementing the market making-related permitted activity should reflect the role of market makers as intermediaries between market participants in different physical locations, at different times and in different sizes. | A-36           | § __.4(b)        | § 13(d)(1)(B)     |
|                          | The interpretation of “block positioner” should be expanded to address the differences between asset classes.  | A-40           | § __.4(b)        | § 13(d)(1)(B)     |
|                          | The Agencies should expressly include interdealer market making-related activities within the permitted activity.  | A-44           | § __.4(b)        | § 13(d)(1)(B)     |
|                          | The Agencies should remove the requirement that a market maker be registered as a dealer or subject to substantive regulation.   | A-47           | § __.4(b)(2)(iv) | § 13(d)(1)(B)     |

| Question in Proposal  | Statement  | Page in Letter | Rule Section     | Statutory Section |
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|                       | The market making-related permitted activity should recognize that arbitrage activities, as the Agencies understand them, can constitute market making-related activities.   | A-49           | § __.4(b)        | § 13(d)(1)(B)     |
|                       | If foreign sovereign debt is not excluded from the Volcker Rule restrictions, the Agencies must ensure that operations of banking entities in foreign jurisdictions are allowed to meet that jurisdiction’s primary dealer and other requirements. | A-51           | § __.4(b)        | § 13(d)(1)(B)     |
|                       | The Agencies should clarify that banking entities can make markets in, and be Authorized Participants for, exchange-traded funds.  | A-51           | § __.4(b)        | § 13(d)(1)(B)     |
| Question 91 (Page 62) | The Proposal’s discussion of what constitutes a market maker “hold[ing] itself out as being willing to buy and sell . . . on a regular or continuous basis” is too narrow to reflect market making in the vast majority of markets                 | A-37           | § __.4(b)(2)(ii) | § 13(d)(1)(B)     |
|                       | The interpretation of “block positioner” should be expanded to address the differences between asset classes.  | A-40           | § __.4(b)        | § 13(d)(1)(B)     |
|                       | The Agencies should ensure that banking entities can be market makers in new or bespoke products, including structured products and transactions driven by customer requests.  | A-46           | § __.4(b)        | § 13(d)(1)(B)     |
|                       | The market making-related permitted activity should recognize that arbitrage activities, as the Agencies understand them, can constitute market making-related activities.   | A-49           | § __.4(b)        | § 13(d)(1)(B)     |
| Question 92 (Page 62) | In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in <i>any</i> market, even the most liquid equity markets.                  | A-26           | § __.4(b)        | § 13(d)(1)(B)     |

| Question in Proposal  | Statement  | Page in Letter | Rule Section      | Statutory Section |
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|                       | The Proposal’s discussion of what constitutes a market maker “hold[ing] itself out as being willing to buy and sell . . . on a regular or continuous basis” is too narrow to reflect market making in the vast majority of markets   | A-37           | § __.4(b)(2)(ii)  | § 13(d)(1)(B)     |
| Question 93 (Page 63) | In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in <i>any</i> market, even the most liquid equity markets.  | A-26           | § __.4(b)         | § 13(d)(1)(B)     |
| Question 94 (Page 63) | The proposed guidance around the “reasonably expected near term demands of clients, customers or counterparties” requirement misconstrues the statutory requirement and does not adequately allow market makers to build and maintain necessary inventory.   | A-41           | § __.4(b)(2)(iii) | § 13(d)(1)(B)     |
|                       | The market making-related permitted activity should recognize that arbitrage activities, as the Agencies understand them, can constitute market making-related activities.   | A-49           | § __.4(b)         | § 13(d)(1)(B)     |
| Question 95 (Page 63) | The Agencies should remove the requirement that a market maker be registered as a dealer or subject to substantive regulation.   | A-47           | § __.4(b)(2)(iv)  | § 13(d)(1)(B)     |
| Question 96 (Page 63) | The Agencies should not require, even in guidance, that market making-related permitted activities be “designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income.” This formulation exceeds statutory intent, prejudices appropriate results for revenue metrics and ignores the fact that, frequently, a <i>bona fide</i> market maker may not be able to provide market making services unless it can benefit from revenues from market movements. | A-30           | § __.4(b)(2)(v)   | § 13(d)(1)(B)     |
|                       | The market making-related permitted activity should recognize that arbitrage activities, as the Agencies understand them, can constitute market making-related activities.   | A-49           | § __.4(b)         | § 13(d)(1)(B)     |

| Question in Proposal       | Statement  | Page in Letter | Rule Section     | Statutory Section |
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| Question 98<br>(Page 63)   | Market making-related hedging should not be subject to the risk-mitigating hedging requirements as long as the hedge positions are designed to mitigate the risk of positions acquired through permitted market making-related activities.   | A-53           | § __.4(b)(3)     | § 13(d)(1)(B)     |
| Question 99<br>(Page 64)   | The Agencies should expressly include interdealer market making-related activities within the permitted activity.  | A-44           | § __.4(b)        | § 13(d)(1)(B)     |
| Question 100<br>(Page 64)  | The Agencies should expressly include interdealer market making-related activities within the permitted activity.  | A-44           | § __.4(b)        | § 13(d)(1)(B)     |
| Question 177<br>(Page 100) | In attempting to reduce market making to a hard-coded set of criteria, the proposed model of market making does not reflect the manner in which market makers function in <i>any</i> market, even the most liquid equity markets.  | A-26           | § __.4(b)        | § 13(d)(1)(B)     |
|                            | The Agencies should not require, even in guidance, that market making-related permitted activities be “designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income.” This formulation exceeds statutory intent, prejudices appropriate results for revenue metrics and ignores the fact that, frequently, a <i>bona fide</i> market maker may not be able to provide market making services unless it can benefit from revenues from market movements. | A-30           | § __.4(b)(2)(v)  | § 13(d)(1)(B)     |
| Question 178<br>(Page 101) | The Agencies should remove the requirement that a market maker be registered as a dealer or subject to substantive regulation.   | A-47           | § __.4(b)(2)(iv) | § 13(d)(1)(B)     |



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| Question 184<br>(Page 102)             | The Agencies should not require, even in guidance, that market making-related permitted activities be “designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income.” This formulation exceeds statutory intent, prejudices appropriate results for revenue metrics and ignores the fact that, frequently, a <i>bona fide</i> market maker may not be able to provide market making services unless it can benefit from revenues from market movements. | A-30           | § __.4(b)(2)(v)   | § 13(d)(1)(B)     |
|  | The Proposal’s discussion of what constitutes a market maker “hold[ing] itself out as being willing to buy and sell . . . on a regular or continuous basis” is too narrow to reflect market making in the vast majority of markets   | A-37           | § __.4(b)(2)(ii)  | § 13(d)(1)(B)     |
|  | The proposed guidance around the “reasonably expected near term demands of clients, customers or counterparties” requirement misconstrues the statutory requirement and does not adequately allow market makers to build and maintain necessary inventory.   | A-41           | § __.4(b)(2)(iii) | § 13(d)(1)(B)     |
|  | The Agencies should remove the requirement that a market maker be registered as a dealer or subject to substantive regulation.   | A-47           | § __.4(b)(2)(iv)  | § 13(d)(1)(B)     |
| Question 357<br>(Page 193)             | The Agencies’ approach to the market making-related permitted activity would have significant deleterious real-world effects on the financial markets and on the investors and customers that rely on such markets for liquidity.  | A-22           | § __.4(b)         | § 13(d)(1)(B)     |
| <b>Underwriting Permitted Activity</b> |  |                |                   |                   |
| Question 64<br>(Page 51)               | The word “solely” should be removed from the “in connection with a distribution” prong of the underwriting permitted activity.   | A-55           | § __.4(a)(2)(iii) | § 13(d)(1)(B)     |

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|                          | The focus on Regulation M distributions in the definition of underwriting would preclude certain <i>bona fide</i> underwriting activities. The definition of distribution should be expanded to not require “magnitude” and to explicitly include any offering of securities by an issuer and any offering by a selling shareholder that is registered under the Securities Act or that involves an offering document prepared by the issuer. | A-58           | § __.4(a)(3)      | § 13(d)(1)(B)     |
| Question 65<br>(Page 51) | The word “solely” should be removed from the “in connection with a distribution” prong of the underwriting permitted activity.  | A-55           | § __.4(a)(2)(iii) | § 13(d)(1)(B)     |
|                          | The Agencies should interpret the “near term demands of clients” prong flexibly to accommodate capital formation.   | A-57           | § __.4(a)(2)(v)   | § 13(d)(1)(B)     |
|                          | The focus on Regulation M distributions in the definition of underwriting would preclude certain <i>bona fide</i> underwriting activities. The definition of distribution should be expanded to not require “magnitude” and to explicitly include any offering of securities by an issuer and any offering by a selling shareholder that is registered under the Securities Act or that involves an offering document prepared by the issuer. | A-58           | § __.4(a)(3)      | § 13(d)(1)(B)     |
| Question 67<br>(Page 51) | The Agencies should interpret the “near term demands of clients” prong flexibly to accommodate capital formation.   | A-57           | § __.4(a)(2)(v)   | § 13(d)(1)(B)     |
|                          | The Agencies should provide greater clarity around the treatment of securities issued in lieu of or to refinance bridge loans.  | A-59           | § __.4(a)(2)(v)   | § 13(d)(1)(B)     |
|                          | The Agencies should expand the definition of underwriter to reflect current market practices.   | A-60           | § __.4(a)(4)      | § 13(d)(1)(B)     |
| Question 69<br>(Page 51) | The word “solely” should be removed from the “in connection with a distribution” prong of the underwriting permitted activity.  | A-55           | § __.4(a)(2)(iii) | § 13(d)(1)(B)     |

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|                          | The focus on Regulation M distributions in the definition of underwriting would preclude certain <i>bona fide</i> underwriting activities. The definition of distribution should be expanded to not require “magnitude” and to explicitly include any offering of securities by an issuer and any offering by a selling shareholder that is registered under the Securities Act or that involves an offering document prepared by the issuer. | A-58           | § __.4(a)(3)      | § 13(d)(1)(B)     |
| Question 71<br>(Page 51) | The word “solely” should be removed from the “in connection with a distribution” prong of the underwriting permitted activity.  | A-55           | § __.4(a)(2)(iii) | § 13(d)(1)(B)     |
|                          | The focus on Regulation M distributions in the definition of underwriting would preclude certain <i>bona fide</i> underwriting activities. The definition of distribution should be expanded to not require “magnitude” and to explicitly include any offering of securities by an issuer and any offering by a selling shareholder that is registered under the Securities Act or that involves an offering document prepared by the issuer. | A-58           | § __.4(a)(3)      | § 13(d)(1)(B)     |
| Question 72<br>(Page 52) | The Agencies should expand the definition of underwriter to reflect current market practices.   | A-60           | § __.4(a)(4)      | § 13(d)(1)(B)     |
| Question 73<br>(Page 52) | The Agencies should interpret the “near term demands of clients” prong flexibly to accommodate capital formation.   | A-57           | § __.4(a)(2)(v)   | § 13(d)(1)(B)     |
|                          | The Agencies should provide greater clarity around the treatment of securities issued in lieu of or to refinance bridge loans.  | A-59           | § __.4(a)(2)(v)   | § 13(d)(1)(B)     |
| Question 76<br>(Page 52) | The Agencies should provide greater clarity around the treatment of securities issued in lieu of or to refinance bridge loans.  | A-59           | § __.4(a)(2)(v)   | § 13(d)(1)(B)     |
| Question 79<br>(Page 53) | The Agencies should provide greater clarity around the treatment of securities issued in lieu of or to refinance bridge loans.  | A-59           | § __.4(a)(2)(v)   | § 13(d)(1)(B)     |

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| <b>Risk-Mitigating Hedging Permitted Activity</b> |  |                |              |                   |
| Question 102<br>(Page 69)                         | The permitted activity should consist of a general statement that risk-mitigating hedging is permitted and encouraged, with the current hard-coded criteria moved to become guidance and a requirement that banking entities adopt risk limits and policies and procedures commensurate with the Agencies' guidance. The Agencies would review risk-mitigating hedging through metrics and examinations. | A-62           | § __.5       | § 13(d)(1)(C)     |
|   | The permitted activity should focus on non-market making-related hedging, leaving market making-related hedging to the market making-related permitted activity.   | A-64           | § __.5       | § 13(d)(1)(C)     |
|   | Coordinated hedging through and by affiliates should be eligible for the risk-mitigating hedging permitted activity.   | A-72           | § __.5       | § 13(d)(1)(C)     |
| Question 103<br>(Page 69)                         | The permitted activity should consist of a general statement that risk-mitigating hedging is permitted and encouraged, with the current hard-coded criteria moved to become guidance and a requirement that banking entities adopt risk limits and policies and procedures commensurate with the Agencies' guidance. The Agencies would review risk-mitigating hedging through metrics and examinations. | A-62           | § __.5       | § 13(d)(1)(C)     |
|   | The permitted activity should focus on non-market making-related hedging, leaving market making-related hedging to the market making-related permitted activity.   | A-64           | § __.5       | § 13(d)(1)(C)     |
| Question 104<br>(Page 69)                         | The Agencies should confirm that banking entities may choose to use any hedging strategy that meets the requirements of the risk-mitigating hedging permitted activity, and do not have to choose the "best hedge" along any specific dimension.   | A-70           | § __.5(b)(2) | § 13(d)(1)(C)     |

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| Question 105<br>(Page 69) | Requiring that a hedging position be “reasonably correlated” to the risk hedged, rather than including correlation as one indicator of hedging activity, could limit valid risk-mitigating hedging activities.   | A-66           | § __.5(b)(2)(iii) | § 13(d)(1)(C)     |
|                           | Coordinated hedging through and by affiliates should be eligible for the risk-mitigating hedging permitted activity.   | A-72           | § __.5            | § 13(d)(1)(C)     |
| Question 106<br>(Page 69) | The permitted activity should consist of a general statement that risk-mitigating hedging is permitted and encouraged, with the current hard-coded criteria moved to become guidance and a requirement that banking entities adopt risk limits and policies and procedures commensurate with the Agencies’ guidance. The Agencies would review risk-mitigating hedging through metrics and examinations. | A-62           | § __.5            | § 13(d)(1)(C)     |
|                           | Requiring that a hedging position be “reasonably correlated” to the risk hedged, rather than including correlation as one indicator of hedging activity, could limit valid risk-mitigating hedging activities.   | A-66           | § __.5(b)(2)(iii) | § 13(d)(1)(C)     |
| Question 107<br>(Page 69) | The permitted activity should consist of a general statement that risk-mitigating hedging is permitted and encouraged, with the current hard-coded criteria moved to become guidance and a requirement that banking entities adopt risk limits and policies and procedures commensurate with the Agencies’ guidance. The Agencies would review risk-mitigating hedging through metrics and examinations. | A-62           | § __.5            | § 13(d)(1)(C)     |
|                           | Requiring that a hedging position be “reasonably correlated” to the risk hedged, rather than including correlation as one indicator of hedging activity, could limit valid risk-mitigating hedging activities.   | A-66           | § __.5(b)(2)(iii) | § 13(d)(1)(C)     |

| Question in Proposal      | Statement  | Page in Letter | Rule Section      | Statutory Section |
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|                           | The “no new significant risks at inception” requirement does not appear to recognize that all hedging activity subjects the banking entity to new, possibly significant risks. Instead, the guidance should incorporate the Agencies’ idea that basis and credit risks, among other risks, may occur as part of valid hedging. | A-68           | § __.5(b)(2)(iv)  | § 13(d)(1)(C)     |
|                           | The Agencies should confirm that banking entities may choose to use any hedging strategy that meets the requirements of the risk-mitigating hedging permitted activity, and do not have to choose the “best hedge” along any specific dimension.   | A-70           | § __.5(b)(2)      | § 13(d)(1)(C)     |
| Question 108<br>(Page 69) | Permitted anticipatory hedging should be explicitly allowed and should not be limited to “slightly” before a risk is taken.  | A-71           | § __.5(b)(2)(ii)  | § 13(d)(1)(C)     |
| Question 109<br>(Page 69) | Requiring that a hedging position be “reasonably correlated” to the risk hedged, rather than including correlation as one indicator of hedging activity, could limit valid risk-mitigating hedging activities.   | A-66           | § __.5(b)(2)(iii) | § 13(d)(1)(C)     |
|                           | The continuing review requirements should focus on the overall portfolio of a trading unit, rather than on individual hedges.  | A-72           | § __.5(b)(2)(v)   | § 13(d)(1)(C)     |
|                           | Policies and procedures are sufficient to address hedging at a level of the organization other than where the risk resides; additional documentation should only be required if a hedge put on two levels above the level of the risk goes beyond the hedging covered by the policies and procedures.                          | A-73           | § __.5(c)         | § 13(d)(1)(C)     |

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| Question 110<br>(Page 70) | The permitted activity should consist of a general statement that risk-mitigating hedging is permitted and encouraged, with the current hard-coded criteria moved to become guidance and a requirement that banking entities adopt risk limits and policies and procedures commensurate with the Agencies' guidance. The Agencies would review risk-mitigating hedging through metrics and examinations. | A-62           | § __.5            | § 13(d)(1)(C)     |
|                           | Requiring that a hedging position be "reasonably correlated" to the risk hedged, rather than including correlation as one indicator of hedging activity, could limit valid risk-mitigating hedging activities.   | A-66           | § __.5(b)(2)(iii) | § 13(d)(1)(C)     |
|                           | The Agencies should confirm that banking entities may choose to use any hedging strategy that meets the requirements of the risk-mitigating hedging permitted activity, and do not have to choose the "best hedge" along any specific dimension.   | A-70           | § __.5(b)(2)      | § 13(d)(1)(C)     |
| Question 111<br>(Page 70) | The permitted activity should consist of a general statement that risk-mitigating hedging is permitted and encouraged, with the current hard-coded criteria moved to become guidance and a requirement that banking entities adopt risk limits and policies and procedures commensurate with the Agencies' guidance. The Agencies would review risk-mitigating hedging through metrics and examinations. | A-62           | § __.5            | § 13(d)(1)(C)     |
|                           | The "no new significant risks at inception" requirement does not appear to recognize that all hedging activity subjects the banking entity to new, possibly significant risks. Instead, the guidance should incorporate the Agencies' idea that basis and credit risks, among other risks, may occur as part of valid hedging.   | A-68           | § __.5(b)(2)(iv)  | § 13(d)(1)(C)     |
| Question 112<br>(Page 70) | The continuing review requirements should focus on the overall portfolio of a trading unit, rather than on individual hedges.  | A-72           | § __.5(b)(2)(v)   | § 13(d)(1)(C)     |

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| Question 114<br>(Page 70)                        | Policies and procedures are sufficient to address hedging at a level of the organization other than where the risk resides; additional documentation should only be required if a hedge put on two levels above the level of the risk goes beyond the hedging covered by the policies and procedures. | A-73           | § __.5(c)    | § 13(d)(1)(C)     |
| <b>Government Obligations Permitted Activity</b> |   |                |              |                   |
| Question 120<br>(Page 72)                        | The permitted activity should include trading in state and municipal agency and authority obligations.  | A-76           | § __.6(a)    | § 13(d)(1)(A)     |
| Question 121<br>(Page 72)                        | The permitted activity should include trading in derivatives on permitted government obligations.   | A-75           | § __.6(a)    | § 13(d)(1)(A)     |
|  | The permitted activity should include trading in state and municipal agency and authority obligations.  | A-76           | § __.6(a)    | § 13(d)(1)(A)     |
| Question 122<br>(Pages 72-73)                    | The permitted activity should include trading in foreign sovereign debt of countries to the extent otherwise permitted by law.  | A-76           | § __.6(a)    | § 13(d)(1)(A)     |
| Question 123<br>(Page 73)                        | The permitted activity should include trading in state and municipal agency and authority obligations.  | A-76           | § __.6(a)    | § 13(d)(1)(A)     |
|  | The permitted activity should include trading in foreign sovereign debt of countries to the extent otherwise permitted by law.  | A-77           | § __.6(a)    | § 13(d)(1)(A)     |
| Question 142<br>(Page 81)                        | The permitted activity should include trading in state and municipal agency and authority obligations.  | A-76           | § __.6(a)    | § 13(d)(1)(A)     |
|  | The permitted activity should include trading in foreign sovereign debt of countries to the extent otherwise permitted by law.  | A-77           | § __.6(a)    | § 13(d)(1)(A)     |



| Question in Proposal                             | Statement   | Page in Letter | Rule Section | Statutory Section |
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| <b>On Behalf of Customers Permitted Activity</b> |   |                |              |                   |
| Question 125<br>(Page 75)                        | The permitted activity defines “on behalf of customers” too narrowly and should include, for example, transactions by a banking entity as principal to facilitate a customer need where the banking entity substantially hedges the resulting principal position. | A-80           | § __.6(b)    | § 13(d)(1)(D)     |
| Question 131<br>(Page 76)                        | The permitted activity defines “on behalf of customers” too narrowly and should include, for example, transactions by a banking entity as principal to facilitate a customer need where the banking entity substantially hedges the resulting principal position. | A-80           | § __.6(b)    | § 13(d)(1)(D)     |
|  | If clearing-related activities are not excluded from the trading account, customer clearing, as well as prime brokerage activities, should be explicitly included in the “on behalf of customers” permitted activity.   | A-82           | § __.6(b)    | § 13(d)(1)(D)     |
| <b>Excluded Transactions</b>                     |   |                |              |                   |
| Question 20<br>(Page 36)                         | Transactions “not based on expected or anticipated movements in asset prices,” such as fully collateralized swap transactions that serve funding purposes, should be exempted from the definition of trading account.   | A-84           | § __.3(b)(2) | § 13(h)(6)        |
|  | The Agencies should exclude activities related to assets received in satisfaction of debts previously contracted from the definition of “trading account.”  | A-85           | § __.3(b)(2) | § 13(h)(6)        |
|  | The Agencies should exclude a banking entity’s clearing-related activities from the “trading account” definition.   | A-87           | § __.3(b)(2) | § 13(h)(6)        |

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|                          | The Agencies should view interaffiliate transactions as part of a coordinated activity for purposes of determining whether a banking entity falls within a permitted activity rather than as separate transactions to which separate “trading account” analyses would apply.                           | A-90           | § __.3(b)(2)         | § 13(h)(6)        |
| Question 30<br>(Page 39) | The exclusion from trading account for repurchase agreements is appropriate, but should be expanded to include transactions related to such agreements and should explicitly clarify that all types of repurchase transactions qualify for the exclusion.  | A-83           | § __.3(b)(2)(iii)(A) | § 13(h)(6)        |
|                          | The exclusion from trading account for securities lending transactions is appropriate, but should be expanded to include transactions related to securities lending operations, such as transactions where a security is purchased to cover a short position or purchased or created in order to lend. | A-85           | § __.3(b)(2)(iii)(B) | § 13(h)(6)        |
| Question 32<br>(Page 40) | The exclusion from trading account for repurchase agreements is appropriate, but should be expanded to include transactions related to such agreements and should explicitly clarify that all types of repurchase transactions qualify for the exclusion.  | A-83           | § __.3(b)(2)(iii)(A) | § 13(h)(6)        |
|                          | The exclusion from trading account for securities lending transactions is appropriate, but should be expanded to include transactions related to securities lending operations, such as transactions where a security is purchased to cover a short position or purchased or created in order to lend. | A-85           | § __.3(b)(2)(iii)(B) | § 13(h)(6)        |
| Question 33<br>(Page 40) | The exclusion from trading account for certain “liquidity management” activities should be expanded to include all positions used in liquidity and other asset-liability management activities.  | A-89           | § __.3(b)(2)(iii)(C) | § 13(h)(6)        |

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| Question 34<br>(Page 40) | The exclusion from trading account for certain “liquidity management” activities should be expanded to include all positions used in liquidity and other asset-liability management activities.  | A-89           | § __.3(b)(2)(iii)(C) | § 13(h)(6)        |
| Question 40<br>(Page 41) | The exclusion from trading account for certain “liquidity management” activities should be expanded to include all positions used in liquidity and other asset-liability management activities.  | A-89           | § __.3(b)(2)(iii)(C) | § 13(h)(6)        |
| Question 41<br>(Page 41) | The exclusion from trading account for certain “liquidity management” activities should be expanded to include all positions used in liquidity and other asset-liability management activities.  | A-89           | § __.3(b)(2)(iii)(C) | § 13(h)(6)        |
| Question 43<br>(Page 41) | Transactions “not based on expected or anticipated movements in asset prices,” such as fully collateralized swap transactions that serve funding purposes, should be exempted from the definition of trading account.  | A-84           | § __.3(b)(2)         | § 13(h)(6)        |
|                          | The Agencies should exclude activities related to assets received in satisfaction of debts previously contracted from the definition of “trading account.”   | A-85           | § __.3(b)(2)         | § 13(h)(6)        |
|                          | The Agencies should exclude a banking entity’s clearing-related activities from the “trading account” definition.  | A-87           | § __.3(b)(2)         | § 13(h)(6)        |
|                          | The Agencies should view interaffiliate transactions as part of a coordinated activity for purposes of determining whether a banking entity falls within a permitted activity rather than as separate transactions to which separate “trading account” analyses would apply. | A-90           | § __.3(b)(2)         | § 13(h)(6)        |

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| <b>Conflicts of Interest</b> |  |                |                    |                   |
| Question 190<br>(Page 109)   | The Agencies should confirm that “clear, timely and effective disclosure” can take the form of either periodic or specific disclosures regarding transactions.   | A-93           | § __.8(b)(2)       | § 13(d)(2)(A)(i)  |
|                              | The Agencies should confirm that a banking entity may conclusively rely on information barriers to avoid a “material conflict of interest.”  | A-95           | § __.8(b)(1)       | § 13(d)(2)(A)(i)  |
| Question 199<br>(Page 110)   | The Agencies should confirm that “clear, timely and effective disclosure” can take the form of either periodic or specific disclosures regarding transactions.   | A-93           | § __.8(b)(2)       | § 13(d)(2)(A)(i)  |
| Question 202<br>(Page 110)   | The Agencies should confirm that “clear, timely and effective disclosure” can take the form of either periodic or specific disclosures regarding transactions.   | A-93           | § __.8(b)(2)       | § 13(d)(2)(A)(i)  |
| Question 206<br>(Page 111)   | The Agencies should confirm that “clear, timely and effective disclosure” can take the form of either periodic or specific disclosures regarding transactions.   | A-93           | § __.8(b)(2)       | § 13(d)(2)(A)(i)  |
| Question 207<br>(Page 111)   | The Agencies should confirm that a banking entity may conclusively rely on information barriers to avoid a “material conflict of interest.”  | A-95           | § __.8(b)(1)       | § 13(d)(2)(A)(i)  |
| Question 211<br>(Page 111)   | Conflicts of interests relating to asset-backed securities should be exempted by the Proposal and addressed solely through Section 621.  | A-96           | § __.8             | § 13(d)(2)(A)(i)  |
| <b>Foreign Exchange</b>      |  |                |                    |                   |
| Question 20<br>(Page 36)     | If the Agencies choose to include foreign exchange swaps and forwards within the definitions of “derivative” and “covered financial position,” transactions in these instruments should be excluded from a banking entity’s trading account. | A-101          | § __.3(b)(3)(i)(B) | § 13(h)(4)        |

| Question in Proposal                       | Statement  | Page in Letter | Rule Section              | Statutory Section |
|--|--|----------------|---------------------------|-------------------|
| Question 43<br>(Page 41)                   | If the Agencies choose to include foreign exchange swaps and forwards within the definitions of “derivative” and “covered financial position,” transactions in these instruments should be excluded from a banking entity’s trading account.   | A-101          | § __.3(b)(3)(i)(B)        | § 13(h)(4)        |
| Question 52<br>(Page 43)                   | The Volcker Rule’s proprietary trading restrictions should not be applied to the well-functioning markets for foreign exchange swaps and forwards, which are integral to global payments and monetary policy and meet essential needs of a broad range of market participants, including small businesses and other end users. | A-97           | § __.3                    | § 13(h)(4)        |
|  | The Agencies are not required to, and should not, include foreign exchange swaps and forwards in the definition of “derivative.”   | A-99           | § __.3(b)(3)(i)(B)        | § 13(h)(4)        |
| Question 55<br>(Page 46)                   | The Volcker Rule’s proprietary trading restrictions should not be applied to the well-functioning markets for foreign exchange swaps and forwards, which are integral to global payments and monetary policy and meet essential needs of a broad range of market participants, including small businesses and other end users. | A-97           | § __.3                    | § 13(h)(4)        |
|  | The Agencies are not required to, and should not, include foreign exchange swaps and forwards in the definition of “derivative.”   | A-99           | § __.3(b)(3)(i)(B)        | § 13(h)(4)        |
| <b>Compliance and Quantitative Metrics</b> |  |                |                           |                   |
| Question 143<br>(Page 85)                  | As the FSOC has suggested, the Agencies should implement the Volcker Rule through a combination of internal compliance policies and procedures, reporting and review of quantitative metrics and supervisory review.   | A-103          | Appendix A,<br>Appendix C | § 13(e)(1)        |

| Question in Proposal      | Statement  | Page in Letter | Rule Section                                 | Statutory Section |
|---------------------------|--|----------------|--|-------------------|
| Question 146<br>(Page 85) | As the FSOC has suggested, the Agencies should implement the Volcker Rule through a combination of internal compliance policies and procedures, reporting and review of quantitative metrics and supervisory review.       | A-103          | Appendix A, Appendix C                       | § 13(e)(1)        |
| Question 155<br>(Page 88) | The Agencies should not impose thresholds for quantitative metrics but should use the metrics to highlight opportunities for further discussion.   | A-106          | Appendix A § I                               | § 13(e)(1)        |
| Question 156<br>(Page 89) | “Trading unit” should be defined at a level that presents its activities in the context of the whole. The appropriate level may differ depending on the structure of a banking entity.                                     | A-104          | Appendix A § II                              | § 13(e)(1)        |
| Question 157<br>(Page 89) | “Trading unit” should be defined at a level that presents its activities in the context of the whole. The appropriate level may differ depending on the structure of a banking entity.                                     | A-104          | Appendix A § II                              | § 13(e)(1)        |
| Question 160<br>(Page 91) | “Trading unit” should be defined at a level that presents its activities in the context of the whole. The appropriate level may differ depending on the structure of a banking entity.                                     | A-104          | Appendix A § II                              | § 13(e)(1)        |
| Question 168<br>(Page 95) | The Agencies should not require the Spread Profit and Loss, VaR Exceedance, Comprehensive Profit and Loss Attribution and Pay-to-Receive Spread Ratio metrics.   | A-107          | Appendix A §§ IV.A.2, IV.B.4, IV.B.5, IV.E.1 | § 13(e)(1)        |
|                           | The Customer-Facing Trade Ratio is flawed. Instead, the Agencies could require each institution to provide information on activities by class of counterparty.   | A-110          | Appendix A § IV.A.3                          | § 13(e)(1)        |
|                           | The Inventory Aging metric is only applicable to cash instruments and should not apply to derivatives. Additional changes to the Inventory Risk Turnover metric should be made to ensure it achieves its intended purpose. | A-112          | Appendix A § IV.D.2                          | § 13(e)(1)        |

| Question in Proposal          | Statement  | Page in Letter | Rule Section                                 | Statutory Section |
|-------------------------------|--|----------------|--|-------------------|
| Question 170<br>(Page 95)     | The Agencies should not require the Spread Profit and Loss, VaR Exceedance, Comprehensive Profit and Loss Attribution and Pay-to-Receive Spread Ratio metrics.   | A-107          | Appendix A §§ IV.A.2, IV.B.4, IV.B.5, IV.E.1 | § 13(e)(1)        |
| Question 174<br>(Pages 96-98) | The Agencies should not require the Spread Profit and Loss, VaR Exceedance, Comprehensive Profit and Loss Attribution and Pay-to-Receive Spread Ratio metrics.   | A-107          | Appendix A §§ IV.A.2, IV.B.4, IV.B.5, IV.E.1 | § 13(e)(1)        |
|                               | The Customer-Facing Trade Ratio is flawed. Instead, the Agencies could require each institution to provide information on activities by class of counterparty.   | A-110          | Appendix A § IV.A.3                          | § 13(e)(1)        |
|                               | The Inventory Aging metric is only applicable to cash instruments and should not apply to derivatives. Additional changes to the Inventory Risk Turnover metric should be made to ensure it achieves its intended purpose. | A-112          | Appendix A § IV.D.2                          | § 13(e)(1)        |
| Question 175<br>(Page 98)     | The Agencies should not require the Spread Profit and Loss, VaR Exceedance, Comprehensive Profit and Loss Attribution and Pay-to-Receive Spread Ratio metrics.   | A-107          | Appendix A §§ IV.A.2, IV.B.4, IV.B.5, IV.E.1 | § 13(e)(1)        |
|                               | The Inventory Aging metric is only applicable to cash instruments and should not apply to derivatives. Additional changes to the Inventory Risk Turnover metric should be made to ensure it achieves its intended purpose. | A-112          | Appendix A § IV.D.2                          | § 13(e)(1)        |
| Question 187<br>(Page 103)    | The Agencies should not impose thresholds for quantitative metrics but should use the metrics to highlight opportunities for further discussion.   | A-106          | Appendix A § I                               | § 13(e)(1)        |
| Question 188<br>(Page 103)    | The Agencies should not impose thresholds for quantitative metrics but should use the metrics to highlight opportunities for further discussion.   | A-106          | Appendix A § I                               | § 13(e)(1)        |

| Question in Proposal       | Statement   | Page in Letter | Rule Section           | Statutory Section |
|----------------------------|---|----------------|------------------------|-------------------|
| Question 189<br>(Page 103) | The Agencies should not impose thresholds for quantitative metrics but should use the metrics to highlight opportunities for further discussion.  | A-106          | Appendix A § I         | § 13(e)(1)        |
| Question 321<br>(Page 166) | The Appendix C compliance regime is overly specific, prescriptive and impractical. It should be replaced with a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations.     | A-113          | § __.20;<br>Appendix C | § 13(e)(1)        |
|                            | The Agencies should permit banking entities to leverage existing compliance regimes, including the level at which compliance is monitored, in order to minimize inefficiencies, unnecessary expense and the potential for conflicting compliance protocols, including the use of existing Board governance protocols. | A-114          | § __.20;<br>Appendix C | § 13(e)(1)        |
| Question 322<br>(Page 166) | The Appendix C compliance regime is overly specific, prescriptive and impractical. It should be replaced with a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations.     | A-113          | § __.20;<br>Appendix C | § 13(e)(1)        |
| Question 323<br>(Page 166) | The Appendix C compliance regime is overly specific, prescriptive and impractical. It should be replaced with a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations.     | A-113          | § __.20;<br>Appendix C | § 13(e)(1)        |
| Question 324<br>(Page 166) | The Appendix C compliance regime is overly specific, prescriptive and impractical. It should be replaced with a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations.     | A-113          | § __.20;<br>Appendix C | § 13(e)(1)        |



| Question in Proposal       | Statement   | Page in Letter | Rule Section                                       | Statutory Section |
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| Question 328<br>(Page 167) | The Agencies should permit banking entities to leverage existing compliance regimes, including the level at which compliance is monitored, in order to minimize inefficiencies, unnecessary expense and the potential for conflicting compliance protocols, including the use of existing Board governance protocols. | A-114          | § __.20;<br>Appendix C                             | § 13(e)(1)        |
| Question 329<br>(Page 167) | The Agencies should permit banking entities to leverage existing compliance regimes, including the level at which compliance is monitored, in order to minimize inefficiencies, unnecessary expense and the potential for conflicting compliance protocols, including the use of existing Board governance protocols. | A-114          | § __.20;<br>Appendix C                             | § 13(e)(1)        |
| Question 360<br>(Page 194) | The Agencies should permit banking entities to leverage existing compliance regimes, including the level at which compliance is monitored, in order to minimize inefficiencies, unnecessary expense and the potential for conflicting compliance protocols, including the use of existing Board governance protocols. | A-114          | § __.20;<br>Appendix C                             | § 13(e)(1)        |
| Question 363<br>(Page 194) | The Agencies should not require the Spread Profit and Loss, VaR Exceedance, Comprehensive Profit and Loss Attribution and Pay-to-Receive Spread Ratio metrics.  | A-107          | Appendix A<br>§§ IV.A.2, IV.B.4,<br>IV.B.5, IV.E.1 | § 13(e)(1)        |
| Question 366<br>(Page 195) | “Trading unit” should be defined at a level that presents its activities in the context of the whole. The appropriate level may differ depending on the structure of a banking entity.  | A-104          | Appendix A § II                                    | § 13(e)(1)        |
| Question 370<br>(Page 196) | The Agencies should permit banking entities to leverage existing compliance regimes, including the level at which compliance is monitored, in order to minimize inefficiencies, unnecessary expense and the potential for conflicting compliance protocols, including the use of existing Board governance protocols. | A-114          | § __.20;<br>Appendix C                             | § 13(e)(1)        |

| Question in Proposal              | Statement  | Page in Letter | Rule Section | Statutory Section |
|-----------------------------------|--|----------------|--------------|-------------------|
| <b>Supervisory Coordination</b>   |  |                |              |                   |
| CFTC Question 8.1                 | In order to avoid the confusion and costs of multiple overlapping regulators, we believe that the Agencies should provide in the final rules that: (i) the Board will have exclusive authority to interpret the Volcker Rule and the final rules; (ii) where more than one Agency has examination authority over a given banking entity, the appropriate Agencies will engage in a coordinated examination of such banking entity under the Volcker Rule; and (iii) an enforcement action under the Volcker Rule may be initiated by an Agency only in consultation with the other Agencies, if any, who participated in the coordinated examination process with respect to the banking entity that is the subject of the action. | A-116          |              | § 13(b)(2)(B)(ii) |
| <b>Phase In and Effectiveness</b> |  |                |              |                   |
| Question 1 (Page 23)              | Banking entities should have the full statutory conformance period to bring activities into compliance with the Volcker Rule. Banking entities should not be required to bring activities into compliance “as soon as practicable” after July 21, 2012.  | A-118          | § 248.31(a)  | § 13(c)           |
| Question 2 (Page 23)              | Banking entities should have the full statutory conformance period to bring activities into compliance with the Volcker Rule. Banking entities should not be required to bring activities into compliance “as soon as practicable” after July 21, 2012.  | A-118          | § 248.31(a)  | § 13(c)           |
|                                   | Requiring banking entities to implement completely the metrics and compliance requirements by July 21, 2012 is inconsistent with the statutory Volcker Rule, is unrealistic and will be counterproductive.   | A-119          | § 248.31(a)  | § 13(c)           |

| Question in Proposal      | Statement  | Page in Letter | Rule Section | Statutory Section |
|---------------------------|--|----------------|--------------|-------------------|
|                           | After the conformance period, the Volcker Rule regulations should be phased in. Final regulations should first apply to the U.S. activities of banking entities and only later to foreign activities of banking entities. Within each of these categories, the regulations should be phased in by asset class or line of business. | A-121          | § 248.31(a)  | § 13(c)           |
| Question 3<br>(Page 23)   | Banking entities should have the full statutory conformance period to bring activities into compliance with the Volcker Rule. Banking entities should not be required to bring activities into compliance “as soon as practicable” after July 21, 2012.  | A-118          | § 248.31(a)  | § 13(c)           |
|                           | Requiring banking entities to implement completely the metrics and compliance requirements by July 21, 2012 is inconsistent with the statutory Volcker Rule, is unrealistic and will be counterproductive.   | A-119          | § 248.31(a)  | § 13(c)           |
| Question 4<br>(Page 23)   | After the conformance period, the Volcker Rule regulations should be phased in. Final regulations should first apply to the U.S. activities of banking entities and only later to foreign activities of banking entities. Within each of these categories, the regulations should be phased in by asset class or line of business. | A-121          | § 248.31(a)  | § 13(c)           |
| Question 144<br>(Page 85) | Requiring banking entities to implement completely the metrics and compliance requirements by July 21, 2012 is inconsistent with the statutory Volcker Rule, is unrealistic and will be counterproductive.   | A-118          | § 248.31(a)  | § 13(c)           |
| Question 147<br>(Page 85) | Requiring banking entities to implement completely the metrics and compliance requirements by July 21, 2012 is inconsistent with the statutory Volcker Rule, is unrealistic and will be counterproductive.   | A-118          | § 248.31(a)  | § 13(c)           |

| Question in Proposal         | Statement  | Page in Letter | Rule Section | Statutory Section |
|------------------------------|--|----------------|--------------|-------------------|
| Question 149<br>(Page 85)    | Requiring banking entities to implement completely the metrics and compliance requirements by July 21, 2012 is inconsistent with the statutory Volcker Rule, is unrealistic and will be counterproductive.       | A-119          | § 248.31(a)  | § 13(c)           |
| <b>Cost-Benefit Analysis</b> |  |                |              |                   |
| Question 348<br>(Page 192)   | The Agencies should conduct a rigorous cost-benefit analysis of the Proposal consistent with the principles laid out in the <i>Business Roundtable</i> decision.   | A-123          |              |                   |
| Question 357<br>(Page 193)   | If the Agencies perform the sort of cost-benefit analysis contemplated in the <i>Business Roundtable</i> decision, we believe they will find that the costs of the Proposal substantially outweigh the benefits. | A-129          |              |                   |
| Question 358<br>(Page 194)   | If the Agencies perform the sort of cost-benefit analysis contemplated in the <i>Business Roundtable</i> decision, we believe they will find that the costs of the Proposal substantially outweigh the benefits. | A-129          |              |                   |
|                              | The Agencies should repropose the rule once they have conducted a meaningful cost-benefit analysis.  | A-131          |              |                   |

## About the Signatories

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