| asset management group

February 13, 2012

By electronic submission

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
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Washington, DC 20581

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
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Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
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Washington, DC 20429

Office of the Comptroller of the Currency
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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to provide the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (the "**Agencies**") with our comments on their proposals to implement the proprietary trading provisions of the Volcker Rule (together, the "**Proposal**").[1]

AMG represents U.S. asset management firms whose combined assets under management exceed $20 trillion. Our clients include, among others, registered

[1] 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); Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds (proposed Jan. 13, 2012).

investment companies, state and local government pension funds, universities, 401(k) or similar types of retirement funds and private funds such as hedge funds and private equity funds.

In our capacity as fiduciaries for millions of individual investors, AMG members rely on the essential liquidity provided by banking entities acting as market makers. As asset managers, we believe that the proprietary trading provisions of the Proposal, if implemented, would drastically disrupt the liquidity that banking entities provide to our clients. As a result, the value of our clients' portfolios would decline, the transaction costs of investing will increase and returns on investments will shrink. The Proposal will also reduce the ability of corporations to raise capital by raising costs, which would harm the real economy by reducing production, wages and job growth.

This harm to the financial markets and real economy is unnecessary. We believe that the Volcker Rule intended to preserve market making liquidity and corporate capital raising by explicitly permitting banking entities to make markets, act as underwriters, hedge their risks and act on behalf of customers.[2] Congress made clear that the Volcker Rule should not be impair the ability of customers, such as our clients, to obtain essential market making and underwriting services from banking entities. The Volcker Rule was intended to orient banking entities toward serving customers like our clients and other end users, rather than proprietary trading. The Proposal does not adequately fulfill this congressional goal. Instead, by straining to eliminate any vestiges of prohibited *proprietary* trading by banking entities at all costs, the Proposal overshoots its purpose and would severely constrict *principal* trading that would benefit customers. We believe that the Proposal needs to be overhauled to achieve its main purpose without sacrificing the welfare of investors.

AMG members rely on the liquidity provided by banking entities acting as market makers.

AMG members are in the business of managing assets for our clients. The amount of assets that we collectively manage represents a significant portion of the financial markets. Thus, when we need to increase or decrease the holdings of our clients, we are liquidity seekers, not liquidity providers.[3] We rely on the financial markets to supply the assets our clients want to buy and absorb the assets we want to sell on behalf of our clients. Often, we can find the liquidity our clients need in some actively traded equities through executing many small orders on exchanges and other trading markets. But far more often, we can only find the liquidity our clients need, without suffering volatile price moves, by dealing with banking entities acting as market makers.

These banking entities act as principal to intermediate the financial markets. The need to sell a position by one asset manager typically does not coincide perfectly with another asset manager's desire to buy that position. Often, many asset managers choose to sell at the same time. Market makers bridge this gap, allowing markets to function

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[2] Bank Holding Company Act § 13(d) (as added by Dodd-Frank § 619).

[3] When we refer to our activities as advisers or as market participants, we refer to the activities of AMG members acting individually, not activities of the AMG itself.

smoothly and, as a result, reducing bid/ask spreads. In today's marketplace, these market makers are largely affiliated with banks. Their market making function reduces customer transaction costs, mitigates customer risk and improves customer returns. If banking entity market makers did not provide this intermediation function, the time and size risks that they are now willing to absorb would instead be assumed by our clients. We do not believe that, at least in the short term, other market participants could fulfill this function.

As an example, AMG members and other asset managers often need to buy or sell a large amount of securities or financial instruments, known in some markets as a "block trade." Asset managers also may decide that it would be prudent to take large positions in interest rate swaps in order to hedge new interest rate exposure in a client's fund or account or may need to sell equity or fixed-income securities in order to satisfy rising redemption requests. Without market makers willing to take the other side of some or all of these positions as principal, an asset manager will likely move the market drastically by trying to access the small trading interest that might otherwise be available in the market. This would greatly increase the cost to our client and the risk of not being able to complete the full transaction. Today, bank market makers are willing and able to take on the position as principal if they are able to warehouse and then hedge the position while waiting to sell out the block over time in order to mitigate the price impact. In this way, banking entities provide a critical service to our clients, keeping prices and costs from escalating.

We believe that the proprietary trading provisions of the Proposal would drastically disrupt the liquidity that banking entities provide to our clients. We believe the Proposal should be amended to allow critical market making-related activities to continue.

The statutory Volcker Rule explicitly permits banking entities to engage in market making-related activity.[4] The Proposal's view of what constitutes this activity is too narrow and will not allow banking entities to provide ongoing liquidity as principal to our clients and other end users of financial instruments. Congress did not mean to disrupt this vital activity. Therefore, we believe the Proposal must be changed to allow banking entities to provide liquidity as underwriters and market makers. We wish to briefly highlight a few of the aspects of the Proposal that we find most problematic from the buy-side's perspective and that we think will most impair banking entities' ability to make markets for our members.

One major problem arises because the market making-related permitted activity assumes that markets themselves are highly liquid, electronic and open to a wide array of end users, similar to agency-based equity markets. Instead, market making, whether done manually or electronically, is a highly nuanced process of trying to assess the demand for an instrument, the likely price direction and the availability and cost of reasonable hedges. Most of this trading activity is conducted by banking entities on a principal basis and many markets are far from liquid. The Proposal's limits on a market maker's ability to hold inventory and derive revenue from market price movements[5] do not accord with

[4] Bank Holding Company Act § 13(d)(1)(B) (as added by Dodd-Frank § 619).

[5] *See* Proposal § __.4(b)(2)(iii), (v).

the fact that, in intermediating in less liquid markets, market makers must take into account, and sometimes benefit from, movements in prices.

Effectively, the Proposal assumes that market makers act like agents without risk of price falls or gains. In reality, this is the exception rather than the norm, particularly in markets other than equities. If market makers affiliated with banks come under suspicion when they buy a position and the price rises, they will no longer be willing to buy from the funds and accounts managed by our members, and these funds and accounts will be left with inefficient and far more costly alternatives for the purchase and sale of our investments. Thus, we strongly urge the Agencies to reorient the market making-related permitted activity to give market makers room to facilitate our orders as principal in the full range of instruments covered by the Volcker Rule.

We believe the Proposal's misunderstanding of markets is particularly problematic in the fixed income and derivatives markets. Fixed income markets comprise a wide range of instruments, with a single issuer often issuing multiple bonds with different spreads and maturities. With this range of bonds comes the benefit of a diverse market in which an asset manager has a number of bonds that may best meet its risk/return preferences, asset-liability management demands for insurance companies and other clients, maturity spectrum requirements or capital structure requirements. The multiplicity of instruments, however, means that liquidity of individual bonds is often relatively limited. As a result, in order to respond to the needs of asset managers and other investors, market makers may have to hold a range of inventory of fixed income securities over significant periods of time. The Proposal's restriction of inventory, which satisfies the near term demands of customers, and the restriction on deriving revenue primarily from related price moves, is therefore extremely problematic for fixed income securities. Market makers must also be able to cost-effectively hedge the fixed income securities they hold in inventory, including on a portfolio basis, which is difficult under the onerous hedging restrictions that require, for example, all hedges to conform to an ambiguous, undefined concept of "reasonable correlation."[6]

In the over-the-counter ("**OTC**") derivatives markets, we enter into derivatives transactions on behalf of our clients in a range of instruments. For example, a member may enter into an interest rate swap to mitigate credit risk or a credit default swap to cost-effectively manage a client's exposure to a corporate issuer. While the Proposal states that a banking entity may be considered a market maker in derivatives when entering into a transaction in response to customer demand and hedging the related exposure,[7] we do not think the language in the Proposal provides sufficient guidance so that our banking entity counterparties can continue to respond to our needs. We think that the Proposal's resulting restrictions on inventory,[8] the use of equity-centric metrics such as Inventory

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[6] *See* Proposal § __.5(b)(2)(iii); *see also* Proposal at 68,875 (Federal Reserve Proposal ("**FRB**") page 66).

[7] The Agencies note 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." Proposal, Appendix B § III.A.

[8] Inventory accumulation is limited by the Proposal's requirement that a trading desk's market making-related activities are "designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties." Proposal § __.4(b)(2)(iii). The Agencies state elsewhere that "*bona fide* market making-related activity may include taking positions in securities in anticipation of customer

Risk Turnover[9] and the difficulty of finding suitable market making-related hedges[10] would create crippling uncertainty for the derivatives counterparties that we enter into trades with on behalf of our clients. We think the unfortunate result could be that these banking entity counterparties will be reluctant to continue to enter into such transactions with our clients.

We believe the Agencies should better reflect the role of derivatives dealers throughout the Proposal, including (as mentioned below) the ability to enter into bespoke trades requested by customers. Otherwise, AMG members will face increased risk from a reduced ability to hedge where banking entities cannot act as counterparties, and increased transaction costs where banking entities are discouraged from entering into derivatives transactions.

Another major problem with the Proposal is that it hinders market makers from entering into block trades. We turn to market makers to meet our demand for block trades for equity or fixed income securities. These block trades, which are entered into with banking entities on a principal basis, permit us to execute sizable trades on behalf of multiple clients in a single transaction at more favorable execution prices. We rely on banking entities to enter into block trades with the funds and accounts that we manage as part of the banking entities' market making activities to bridge the gap in price and time until others in the market are willing to trade on the positions. The Proposal appears to allow "block positioner" activity,[11] but turns for guidance to a narrow SEC rule designed to limit credit to market makers that requires, among other things, the market maker to "sell the shares composing the block as rapidly as possible commensurate with the circumstances."[12] This provision may be appropriate for certain liquid equities, but is not feasible for the less liquid financial positions that the Volcker Rule covers, including fixed income instruments, OTC derivatives and many equity securities. In any event, a mandate to sell the components of a large block of less liquid positions rapidly would overwhelm the market, undercutting the price the market maker can get as it works out of the block. In addition, the block positioner guidance in the Proposal only applies to the definition of market maker, and not the other restrictions on market maker activity. This requires market makers positioning blocks, for example, to second-guess whether, in working out of the position slowly to avoid depressing the price, they are seeking to

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demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties." Proposal at 68,871 (FRB 58). This statement's repetition of the "reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties" requirement will likewise prevent market makers from building the inventory in advance of customer demand.

[9] Proposal, Appendix A § IV.D.1.

[10] To qualify as market making-related permitted activity, the Proposal requires a purchase or sale of a covered financial position to be "purchased or sold to reduce the specific risks to the covered banking entity in connection with and related to individual or aggregated positions, contracts or other holdings acquired pursuant to [the market making-related permitted activity]" *and* to "meet[] all of the requirements described in [the risk-mitigating hedging permitted activity]." Proposal § __.4(b)(3). This requirement places a double burden to qualify as a hedge under the market making-related permitted activity.

[11] Proposal at 68,871 & n.151 (FRB 57 & n.151).

[12] *See* 12 C.F.R. § 240.3b-8(c)(4)(iii).

generate revenue from price movements. Finally, a market maker may only be willing to position a block if it is able to hedge the risk of that trade and, as a result, the fact that the risk-mitigating hedging is overly narrow is also problematic. Accordingly, the "block positioner" provision is not sufficient to ensure that the funds and accounts managed by our members will be able to continue to experience the efficiency and cost-effectiveness of block trades entered into with banking entities. We believe the Agencies should explicitly state that banking entities meet all the requirements of the market making-related permitted activity to the extent they enter into block trades for customers and for the related trades entered into to support that block trade. Otherwise, these banking entity counterparties may be reluctant to enter into such block trades with our clients.

A further problem with the Proposal is that its provisions, which are designed to purge banking entities of proprietary trading at all levels of the banking entities' organization, including probing trade-by-trade and "trading unit" functions,[13] interfere with banking entities' ability to structure their operations to hedge risks and allocate capital efficiently. As a result, the hedging exemption may not be available for trades that are otherwise used to hedge or manage a banking entity's risks. For example, program risk trading, a strategy often employed by investment funds trading equity securities or other instruments on a principal basis, enables these funds to trade multiple securities in a single transaction swiftly and efficiently. This enables fund advisers to trade securities for their clients more cost-efficiently and better manage flows into and out of funds. In conducting program risk trading, a banking entity may hedge trades with purchases or sales of securities or derivatives made by different trading desks or groups across the banking entity. The ability to aggregate correlated principal risks carried by the larger trading unit allows for a cost-effective hedge against the movement in the price of the underlying exposures. We believe the Agencies should avoid focusing on the microlevel operation of the banking entity and evaluate their activities across the wider trading organization to allow program-wide risk management.

A final problem that we would like to highlight is the negative approach the Proposal takes to the customer service activities of banking entities. The Proposal appears to assume that, even when banking entities are entering into principal transactions at our request, this principal activity is under suspicion unless proven otherwise.[14] We worry that this approach will chill the market making activities of the banking entity counterparties of our clients by making such activities subject to *ex post* inquiry by examiners. This is particularly problematic in the case of customized transactions, for which a banking entity would have limited ability to prove that there has historically been a market for the particular product. We believe that this approach should be reversed so not all trades are presumed to be proprietary trading, to encourage market makers to engage in market making-related transactions as part of customer-oriented business. We further believe that the Agencies should explicitly state that a banking entity's general willingness to engage in bespoke transactions is sufficient to make them a market maker in unique products.

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[13] *See* Proposal, Appendix A §§ I, III.A.

[14] *See* Proposal, Appendix B § III.A.

The Proposal's negative approach to banking entities' principal activities will harm our customers and the financial system more broadly.

As stated above, we rely on banking entities to serve as market makers and underwriters. We believe that the Proposal, as currently drafted, would deter them from continuing to serve in that those capacities. In this section, we provide three specific examples of the negative consequences that could result for our members and the financial markets more broadly.

Portfolio Values will Decrease

The price of a financial instrument depends, among other factors, on the buyer's perceived ability to resell it in the secondary market, and the cost of doing so, should he or she wish to sell. As a result, as liquidity decreases and bid/ask spreads increase, the demand for and price of financial instruments also decreases. The Proposal could, therefore, decrease the value of the assets held by our clients. This decrease in value would directly shrink the savings of the investors in the funds and accounts, retirees, pension plan beneficiaries and other investors who rely on us to invest their earnings.

Transaction Costs will Increase

As liquidity decreases, the cost of entering into transactions increases. These increased transaction costs will decrease the return of our clients' funds, which will ultimately decrease the value of investments of, for example, retiree 401(k) accounts. Oliver Wyman has estimated that the loss of liquidity could cost investors between $1 billion and $4 billion per year in transaction costs as the level and depth of liquidity decreases.[15]

Demand for, and Price of, Corporate Issuances Will Decrease

Corporate issuers rely on the capital markets to raise funds. Asset managers buy these issuers' securities and, by doing so, fund new projects and jobs at those issuers. Asset managers and other market participants are willing to pay the prices they do for primary issuances of corporate securities because of the existence of a liquid secondary market, intermediated by banking entities acting as market makers, that stands ready to purchase the securities from the funds and accounts managed by asset managers. If liquidity in the secondary market decreases and bid/ask spreads increase, the price investors will pay for issued securities will decrease also, reducing the amount of capital available to fund growth. This decrease will be significant—Oliver Wyman has projected that this liquidity reduction could increase issuer borrowing costs by $12-$43 billion.[16] The impact will be even more damaging if banking entities are limited in trading OTC derivatives as many of us will be unwilling to purchase corporate bond positions on behalf of our clients if we cannot hedge the credit risk.

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[15] Oliver Wyman, *The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity* (Jan. 2012), at 4.

[16] *Id.* at 4.

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The AMG thanks the Agencies for the opportunity to comment on the Proposal. Should you have any questions, please do not hesitate to call the undersigned at 212-313-1389.

Respectfully submitted,

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