THE FINANCIAL SERVICES ROUNDTABLE
Financing America's Economy

Building Success. Together.

April 16, 2012

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

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("**SIFMA**"), the American Bankers Association, The Financial Services Roundtable and The Clearing House Association[1] appreciate the opportunity to comment on the Commodity Futures Trading Commission's (the "**Commission's**") proposed rules implementing new Section 13 of the Bank Holding Company Act of 1956 (the "**Volcker Rule**").[2] These proposed rules largely mirror the rules proposed by the Agencies[3] in October 2011 (collectively, the "**Proposal**").[4]

On February 13, 2012, we submitted comments regarding the Proposal to the Agencies, including the Commission. Our comments were divided into a letter on the proprietary trading provisions of the Proposal (the "**February 13 Prop Letter**") and a letter on

[1] Further information about the signatories is available in Annex A.

[2] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (proposed Feb. 14, 2012) (the "**Proposal**").

[3] 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 Commission. 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-AD05 (CFTC).

[4] 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 covered funds provisions of the Proposal (the "**February 13 Funds Letter**," together the "**February 13 Letters**").[5] In this letter, we focus our comments on issues that are particularly relevant to the Commission and respond to specific questions asked by the Commission. In particular, our comments address the following areas:

- the costs of the Proposal substantially outweigh the benefits, and the Commission's cost-benefit analysis is insufficient;
- the swap dealing markets are not well described by the hard-coded criteria in the Proposal's permitted activities. These criteria should be recast as guidance, which would be incorporated in policies and procedures overseen by the regulators through metrics and examinations;
- the Proposal's negative presumptions are not consistent with the statute and thus inappropriately limit the scope of congressionally-permitted swap activities;
- the Proposal's implementation of the market making-related permitted activity is overly narrow and does not encompass the market making-related activities of Commission-registered swap dealers;
- interdealer transactions are a critical component of market making in swaps;
- 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. For example, arbitrage activities related to customer needs should be considered market making-related;
- interaffiliate transactions are a critical component of risk management and swap dealer activity;
- the Commission should not equate status as a "swap dealer" with market making activities under the Volcker Rule;
- the Proposal's implementation of the risk-mitigating hedging permitted activity is overly narrow and does not accord with the use of swaps as hedges or congressional intent to maintain the critical swap dealing function of banking entities;
- quantitative metrics should serve as signals to highlight opportunities for further discussion of the activities of the trading unit rather than as bright-line thresholds;

[5] SIFMA also submitted comment letters specifically addressing (i) municipal securities and tender option bonds and (ii) securitization and insurance-linked securities transactions. SIFMA's Asset Management Group submitted a separate letter on the Proposal's proprietary trading provisions.

- the proposed metrics should be revised and the Commission should not require reporting of any metric that does not provide meaningful data for Commission-regulated instruments;

- "trading unit" should not be defined too narrowly. It should be defined at a level that presents the unit's activities in the context of the whole and that accounts for the scope of the market in which the trading unit operates;

- the Proposal's definition of "commodity pool" is overly broad;

- the Commission 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;

- the government obligations permitted activity should include trading in derivatives on permitted government obligations;

- the Commission should exempt from the "trading account" all activities, such as repurchase agreements and transactions related to such agreements, that "are not based on expected or anticipated movements in asset prices;"

- the Commission should confirm that "clear, timely and effective disclosure" to mitigate conflicts of interest can take the form of either periodic or specific disclosures regarding transactions;

- as the Commission intimated, coordination between the Agencies is critical for effective implementation of the Volcker Rule; the Board should have exclusive authority to interpret the Volcker Rule and the final rules, and the Agencies should coordinate examination and enforcement where appropriate;

- the Commission should join with the other Agencies in one common final rule, even if elements of that common rule are inapplicable to entities under the Commission's jurisdiction; and

- the Agencies should repropose Volcker Rule regulations before finalizing them.

The costs of the Proposal substantially outweigh the benefits, and the Commission's cost-benefit analysis is insufficient.

The potential costs to the financial markets, investors and corporate issuers from incorrectly implementing the Volcker Rule are enormous.[6] Many commenters, including

[6] 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 (…continued)

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. AllianceBernstein rightly warns 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 market participants to meet their legally required obligations to investors and other stakeholders."[7]

Many of the costs of the Proposal result not from the statute, but from the discretionary positions adopted by the Agencies, including the Commission, in the Proposal. For example, the Proposal (but not the statute) requires that any hedging transaction be "reasonably correlated . . . to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate."[8] 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."[9] As we discuss below,[10] such a concept is difficult to apply to the swap marketplace. The Commission's 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 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 unspecified.

(continued…)

$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) (hereinafter "**Oliver Wyman 2012 Study**"). *See also* Darrell Duffie, Stanford University, *Market Making Under the Proposed Volcker Rule* at 3 (Jan. 16, 2012) (hereinafter "**Duffie Analysis**") (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").

[7] 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").

[8] Proposal § __.5(b)(2)(iii).

[9] 77 Fed. Reg. at 8361.

[10] See the discussion beginning on page 21.

The Commission has improperly neglected to consider whether there is any economic justification for such a rigid provision.

The Commission has also failed to consider secondary costs that could be imposed by the Proposal's narrow construction of the permitted activities. For example, as we discuss below,[11] the Proposal's 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 Commission consider these kinds of secondary effects that could impose huge costs on financial markets and the economy.

It is axiomatic that such a far-reaching impact warrants a thoughtful and complete cost-benefit analysis. In the Proposal, however, the Commission has conducted an exceptionally cursory analysis. This is a fatal flaw that must be remedied by the Commission. Under a complete cost-benefit analysis, the Commission 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,[12] the *Business Roundtable* court articulated a framework that should be 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."[13] *Business Roundtable* also makes clear that agencies must explicitly consider every important problem posed by a rule.[14] 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.[15] Under this standard, agencies may not "duck[] serious evaluation of the costs that could be imposed."[16]

The Commission is required to consider costs imposed by the Proposal under a variety of statutes, an executive order and agency policy statements. The limited cost-benefit

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[11] See the discussion beginning on page 9.

[12] *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

[13] *Id.* at 1148-49.

[14] *See id.* at 1151.

[15] *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).

[16] *Id.*

analysis the Commission has conducted falls 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**"), the Commission 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.[17] The Commission claims that the Proposal would have no such impact, but provides no meaningful explanation for that conclusion.[18] The Commission's 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. Here, small entities will be "directly affected and therefore regulated,"[19] 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 entities will therefore have diminished access to the activities prohibited or heavily restricted by the rule.

  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.

- **Executive Order:** The Commission, like the other Agencies, has announced its intention to comply with the principles contained in an executive order requiring cost-benefit analyses.[20] As a result, the Commission should perform the thorough cost-benefit analysis of the Proposal contemplated by that executive order.

[17] *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.

[18] *See* 77 Fed. Reg. at 8421.

[19] *See Aeronautical Repair Station Ass'n, Inc. v. FAA*, 494 F.3d 161, 177 (D.C. Cir. 2007).

[20] *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 Executive Order emphasizes several guiding principles, including that: agencies consider the costs and benefits of their regulations and choose the least burdensome path.").

For the reasons stated above, the Commission has failed to provide an adequate economic assessment of the Proposal, as it is legally required to do.

The swap dealing markets are not well described by the hard-coded criteria in the Proposal's permitted activities. These criteria should be recast as guidance, which would be incorporated in policies and procedures overseen by the regulators through metrics and examinations.

As discussed in greater detail below and in our February 13 Letters, the Agencies, in attempting to craft the current Proposal to stop certain proprietary trading on the one hand and preserve beneficial market activities on the other, have nonetheless created a problematic Proposal that strays significantly from congressional intent. The problems of this Proposal are particularly troublesome for swap dealers. The Proposal could limit the ability of end users to access the risk management products offered by swap dealers, thereby forcing end users either to warehouse more risk or expend more resources to manage their risk, detracting from core business activities. The Proposal can be reoriented to avoid much of this negative impact. Specifically, we recommend that, rather than seeking to scrutinize every transaction in search of possible prohibited proprietary trading, the Proposal be crafted to protect the ability of banking entities to engage in the critical financial intermediation explicitly permitted by Congress. The Proposal should avoid the all-too-familiar error of spending disproportionate resources trying to reduce or eliminate every last vestige of the problem Congress was attempting to address.[21] Congress's aim is accomplished if the activities posing the bulk of the perceived risk are regulated; every ounce of banking entity behavior that might pose such risk need not be regulated, particularly if doing so poses disproportionate negative consequences.

The statutory Volcker Rule is directed at requiring banking entities to eliminate their proprietary trading businesses, other than those specifically permitted. Congress recognized that banking entities must be allowed to fully engage in statutorily permitted activities, including customer-focused principal trading. Therefore, to foster permitted customer-oriented business, the Proposal's hard-coded criteria for market making and risk-mitigating hedging activities should be recast as guidance focused on differentiating 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 willingness to enter into swap contracts with customers, but also includes anticipatory swap positions and swaps with other dealers.[22]

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[21] *See* Stephen Breyer, Breaking the Vicious Circle: Toward Effective Risk Regulation 11 (1993).

[22] As such, as discussed beginning on page 16 below, we strongly believe that interdealer trading activities are critical to market making and are thus, at a minimum, market making-related.

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 and discussed further below,[23] 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. We believe this reorientation would ensure that covered banking entities avoid prohibited activity while preserving deep and liquid financial markets.

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. Indeed, the approach is consistent with the approach advocated by the Financial Stability Oversight Council ("**FSOC**") in its study on implementation of the Volcker Rule and, in particular, in the study's proposed framework for effectively addressing the challenge of distinguishing permissible from impermissible proprietary trading. The FSOC asserts that "one benefit of th[e] approach[] is that [it is] 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."[24] As the FSOC's study was mandated by Congress to inform and help guide the Agencies' rulemaking,[25] it should be given significant weight in consideration of the final rule.

The Proposal's negative presumptions are not consistent with the statute and thus inappropriately limit the scope of congressionally-permitted swap activities.

As stated in the February 13 Prop Letter,[26] a key conceptual flaw with the Proposal is its focus on prohibited behavior, as expressed through negative presumptions, rather than congressionally-permitted behavior. Throughout the Proposal, the Agencies assume that activities are prohibited unless proven otherwise. These negative presumptions are further reflected in the Proposal's reliance upon hard-coded criteria to define permitted activities—such

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[23] See the discussion beginning on page 24.

[24] FSOC Report, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds 32 (Jan. 18, 2011) ("**FSOC Study**").

[25] Bank Holding Company Act § 13(b)(1) (as added by Dodd-Frank § 619).

[26] February 13 Prop Letter at 3-4, A-13, A-24-A-25.

criteria having been drafted primarily with markets more liquid than the swap market in mind—and the fact that the failure to meet any single criterion disqualifies the trading unit from engaging in the permitted activity.

These negative presumptions are inconsistent with explicit congressional intent to allow useful principal activity, including the critical financial intermediation activity that is swap dealing. The statutory Volcker Rule clearly allows the permitted activities notwithstanding the fact that they may constitute proprietary trading. The statute, therefore, does not imply a regulatory construction that would forbid an otherwise permitted activity merely because it involves proprietary trading. Rather, under the statute, the only relevant question for the rule to address is whether the activity is truly market making, hedging, underwriting, or some other permitted activity. The Proposal's use of negative presumptions is the opposite approach and therefore inconsistent with the statute. The negative presumption approach is also inconsistent with the historical approach that the Agencies have taken in supervising banking entities, which would have formed Congress's expectation of how the Volcker Rule would be implemented.

Finally, the negative presumption approach is inconsistent with the existence of a statutory backstop for activities that are overly risky or involve significant and irreconcilable conflicts of interest. These backstops independently address the risks that may arise under the permitted activities. The existence of such a backstop makes it clear that the relevant question at the "permitted activity" stage of analysis should only be whether the activity is truly market making-related, risk-mitigating hedging or any other statutory permitted activity, as the question of whether it is nonetheless overly risky is handled by the backstop provisions.

The Proposal's implementation of the market making-related permitted activity is overly narrow and does not encompass the market making-related activities of Commission-registered swap dealers.

The Proposal's implementation of the market making-related permitted activity is based on overly narrow hard-coded criteria.[27] Of particular concern to the Commission, the market making-related permitted activity is insufficient to allow Commission-registered swap dealers to engage in their key market making role in the swap markets. The Proposal's approach is inconsistent with the FSOC Study's recognition of the need "to preserve banking entities' ability to engage in critical financial intermediation."[28] In the swap market, the "critical intermediation" business to be protected and preserved within the market making-related permitted activity is "swap dealing" itself. The market making-related activities exemption should be interpreted to implement faithfully statutory language permitting "market making-*related*" activity and permit activities and trading "*in connection with* . . . market-making-*related*

[27] If the Commission chooses not to adopt our recommendation to exclude commodity forwards and foreign exchange forwards from the Volcker Rule as proposed in the discussion beginning on page 34, then we would propose applying this letter's other recommendations, to the extent they are relevant, to forwards markets as well as to swap markets.

[28] FSOC Study at 5.

activities."[29] In the swap market, this will protect and preserve the entirety of the critical intermediation business of swap dealing.

Swap dealers should be able to enter into transactions as "market makers" if they are in 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 swaps on their books. 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 activities, inventory building in anticipation of customers' unique demand requirements, a focus on offering bespoke swaps to customers, building relationships with customers and providing sales coverage, and participating in the swap dealer market in order to serve customer demand.

As we describe in more detail below, the swap market is by nature illiquid. The Proposal's hard-coded criteria, however, do not appear to account for the unique nature of this market. Accordingly, we recommend that the final rule recognize the illiquid nature of swaps and propose the Agencies recast the hard-coded criteria as tailored guidance to regulate market making-related permitted activities.

Acting as a Market Maker in Less Liquid Instruments

The Proposal states initially that one "core element" of the market making-related permitted activity is 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."[30] In largely importing the Securities Exchange Act and Regulation SHO definitions of a "market maker," the Proposal heavily depends upon the model of a market maker in liquid equities, whose characteristics are the exception rather than the norm for most covered, principally-traded financial instruments, including swaps. The Agencies do make some adjustments for these less liquid markets, which presumably include swap markets. The Agencies state that the permitted activity includes:

- 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.[31]

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

[30] Proposal § __.4(b)(2)(ii); 77 Fed. Reg. at 8355.

[31] 76 Fed. Reg. at 68,871.

Unfortunately, even this "less liquid" framework does not work for swap activity. In most swap markets, "regular" quotation systems do not exist. Swap dealers frequently enter into new and bespoke swaps specifically tailored to their counterparty's needs. A swap market maker has no fixed responsibilities to trade and may not offer a price at a given moment due to a variety of factors unrelated to speculation. For example, for many interest rate products there can be a number of different maturities at which the product can be traded. However, market makers in these products do not generally disseminate unsolicited price quotations because demand would be lacking for most of the products.

Similarly, there may be little data on "historical customer liquidity and investments needs" upon which to base an analysis of appropriate transaction volumes and risk. Instead, swap dealers serve as market makers by being willing to provide customers with prices to enter into swap transactions, including bespoke swaps, that may be uncommon or unique. The requirement that such a market maker "[h]old[] [itself] out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis" would not appear to encompass the banking entities that act as an "immediate" market maker to accommodate unique customer requests in one-off transactions, except perhaps as block positioners.

Moreover, 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."[32] 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 regarding a customized interest rate swap, that trading desk should be considered a market maker when it engages in a transaction in that related product.

Accordingly, for the purpose of ensuring that swap dealer activity is covered under the Proposal, it is critical that the Agencies clarify that a 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.

Reasonably Expected Near-Term Demand

The market making permitted activity requires that "[t]he market making-related activities of the trading desk or other organizational unit that conducts [a] purchase or sale are, with respect to the covered financial position, designed not to exceed the reasonably expected

[32] 77 Fed. Reg. at 8355-56.

near term demands of clients, customers, or counterparties."[33] The Commission notes that a market maker would need to 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."[34]

Because trades in any particular swap may be infrequent and the particularized requirements of customers that will inform their demand for such instruments are very hard to predict, it is unclear how a market maker that needs to build and maintain inventory would satisfy the above requirements. 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."[35] 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 not ancillary, but, in fact, is integral to market making activity for swap dealers for a number of reasons.

The statement from the Preamble requires revision first because it limits itself to "securities," whereas inventory is crucial to market making in all covered financial products. It makes no sense that, 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 problematic because it is effectively a restatement of the "near term demand" requirement in 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.

As market makers, swap dealers facilitate trading by standing ready to buy and sell. In a very liquid market, such as equity securities, market makers are able to sell securities they buy, and buy securities they need to sell, relatively quickly. Because swap markets are less liquid than other markets, market makers must buy and hold positions in their inventory longer than in other markets. Unless the final rule very clearly permits this type of inventory management activity, market makers simply will not be able to provide the type of intermediation services that underlie the swap market. In interpreting the statutory term "designed not to exceed . . . reasonably expected near term demands,"[36] the Proposal must

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[33] Proposal § __.4(b)(2)(iii).

[34] 77 Fed. Reg. at 8357.

[35] 77 Fed. Reg. at 8356-57.

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

provide a reasoned judgment.[37] Here the Proposal's restrictive approach to inventory holding periods, in combination with the uncertainty associated with the phrase "reasonably expected near term demands," would significantly decrease the liquidity of the swap market because it would result in market makers being less willing to transact in positions that they are not confident they can dispose of quickly. In short, "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.

The Critical Role of Banking Entities as Swap Dealers and as Financial Intermediaries

Swap dealers are the market makers for the Commission-regulated swap markets. Customers turn to swap dealers to help them manage risk and decrease the price volatility of their assets. The swap dealer will be willing to provide them a price for either standardized or bespoke swaps because the swap dealer has the requisite knowledge and infrastructure to do so. Due to the low liquidity and few participants in any particular swap instrument, in order to serve customers, swap dealers must take these positions on as principal positions and hedge them with other swaps or in the cash market.

In many illiquid swap categories, swap dealers do not publish two-sided quotations or specifically hold themselves out as willing to do particular swap contracts. Nonetheless, they communicate to end users and other dealers their willingness to accommodate customer demand in a range of swaps within a swap category. Often, that swap cannot be readily offset with a mirror transaction and must be hedged through different instruments This is the essence of swap dealing.

The role of swap dealer has historically been filled by banking entities to a large degree because swap dealers typically:

- are highly sophisticated entities that can understand, price and hedge the risks (including basis risk) presented by the positions customers wish to enter into;
- have the operational infrastructure necessary to execute swap transactions and access the many markets in which swap trades are hedged;
- are creditworthy counterparties in order to allow their counterparties to gain the benefit of swap transactions without taking on undue credit risk; and
- are highly capitalized (even more so with the advent of the Commission's proposed capital and margin rules for swap dealers).

Particularly in light of the Commission's new Title VII swap dealer regulation, it is unlikely that a significant number of non-banking entities will meet these key characteristics in a wide range of swaps. As the Commission noted in that rulemaking, characteristics of swap dealers and security-based swap dealers include that "[d]ealers tend to accommodate demand for swaps and security-based swaps from other parties" and "tend to be able to arrange customized terms for

[37] *Motor Vehicle Mfrs. Ass'n of United States v. State Farm Mutual Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

swaps or security-based swaps upon request, or to create new types of swaps or security-based swaps at the dealer's own initiative."[38] The Commission explained further that swap dealers "[g]enerally express[] a willingness to offer or provide a range of financial products that would include swaps or security-based swaps."[39]

Therefore, it is critical that the Volcker Rule regulations recognize the way in which market making in swaps differs from market making in other instruments, particularly in liquid, exchange-traded equities. Unfortunately, the Proposal's market making-related permitted activity couches market making in terms of such a liquid, exchange-traded equity model in which market makers are simple intermediaries akin to agents. Despite limited references to less stringent market maker standards for less liquid instruments, this archetype of liquid equity market making pervades the market making-related provisions of the Proposal and needs to be changed to accommodate swap dealer activity.[40]

Market Making in Bespoke Instruments

As noted above, banking entities perform a critical function in serving client needs by entering into swaps specifically tailored to the unique risk a client is looking to hedge. Such swaps are often known as "bespoke swaps." Without access to such bespoke swaps, end users would be left with basis risk between the risks they are looking to hedge and the standardized instruments available to them. As a result, offering such bespoke swaps to meet clients' needs is a customer-focused activity that the statutory Volcker Rule is meant to protect.

Unfortunately, the permitted activity for transactions done "on behalf of customers" is currently so narrow that, unless it is broadened substantially, it may not suffice to accommodate bespoke swaps or a meaningful population of customer-driven transactions. Substantially expanding the discussion in the Proposal regarding qualifying behaviors for purposes of the "holding out" criterion in the draft market making-related permitted activity, including elaborating the discussion regarding block positioning to encompass normal transaction sizes in instruments traded infrequently, could partially address this problem. However, the description of the market making-related permitted activity should be expanded generally to expressly address the illiquid nature of the swap market, including explicit application to transactions in bespoke swaps 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, trades with a customer focus should fall within the market-making exemption, regardless of

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[38] 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, 80,176 (proposed Dec. 21, 2010).

[39] *Id.* at 80,178.

[40] *See State Farm*, 463 U.S. at 43 (agency is "arbitrary and capricious" when it fails to consider an "important aspect of the problem").

whether the trading unit has made markets in that type of instrument with other customers before or whether there is an active market for that instrument.

Sources of Revenues

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 . . . [a]ppreciation in the value of covered financial positions it holds in trading accounts [or] [t]he hedging of covered financial positions it holds in trading accounts."[41] We believe that this requirement is particularly problematic in the context of swaps.

Revenue sources differ significantly by asset class. In commodities markets, dealers are more likely to retain some risk from a transaction executed for a customer because they cannot perfectly offset the risk by hedging. For example, if a market maker buys power from a client, it may need to hedge its position by selling natural gas, which is the best hedge available but not a perfect offset. Accordingly, this hedge may generate some profit or loss if power prices move relative to natural gas prices. Indeed, Appendix B includes commentary stating that the appropriate composition of revenues will differ based on asset class.[42] We applaud the Agencies' reflecting an appreciation of differences among asset classes in Appendix B and elsewhere in the Proposal. We encourage the Agencies to adhere to and further deepen that understanding when they review and evaluate quantitative measures during the conformance period and thereafter.

Moreover, in many markets, revenues from "[h]edging of covered financial positions [the market maker] holds in trading accounts"[43] 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. The Agencies understand this approach 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."[44] This form of market making through hedging, however, arises in markets for other covered financial positions, including futures, and should be allowed in those markets as well.

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 artificial revenue constraints should be part

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[41] Proposal § __.4(b)(2)(v).

[42] 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.

[43] Proposal § __.4(b)(2)(v)(B).

[44] Proposal, Appendix B § III.A.

of the express factors in the rule. If the Agencies believe it is necessary to address this concept explicitly in the final rule, we believe source of revenue, similar to the other proposed hard-coded criteria in § __.4(b)(2), should be at most guidance into which the Agencies incorporate our comments above, including revenue generation through hedging.

Interdealer transactions are a critical component of market making in swaps.

We agree with the Commission's 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 205 of the Preamble states that, for securities executed on an organized exchange, a customer includes 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 includes "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."[45]

These statements from the Preamble recognize that interdealer market making occurs where brokers or other swap dealers act as customers. However, the Commission should expressly incorporate providing liquidity to other swap dealers into the rule text by clarifying that, whether or not conducted on an organized trading facility or exchange, interdealer trading driven by liquidity needs is at a minimum market making-*related* activity, if not pure market making,[46] and is permitted. The Commission should clarify that the nature of the trading relationship determines whether an activity is market making-related, not the characteristics of the parties to the transaction.

Interdealer liquidity is critical to the market making function. In many swap 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, and also ensures more predictable and less volatile markets. Interdealer trading enables swap dealers to gain essential information about pricing and market depth. Market makers will make trades, often with other dealers, to test the depth of markets at particular price points to gain a better sense of supply and demand. Such interdealer trading helps them to offer customers more accurate and efficient pricing. Moreover, interdealer trading ensures that swap dealers are able to find risk-mitigating hedges for their exposures in the less liquid swap markets, enabling swap dealers to provide this market making service to customers. The FSOC acknowledged 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,

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[45] 77 Fed. Reg. at 8376 n.205.

[46] See the discussion of the distinction between market making and market making-related activities beginning on page 17.

market makers are often forced to trade with non-customers in order to appropriately meet the future expected customer demand."[47]

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. 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.[48] This documentation requirement is unnecessary to achieve the purposes of the section, as this form of interdealer trading can be easily explained to the Agencies' examiners.

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. For example, arbitrage activities related to customer needs should be considered market making-related.

The statutory Volcker Rule permits "[t]he purchase, sale, acquisition or disposition of securities and other instruments . . . in connection with . . . market-making-*related* activities."[49] As such, the statute explicitly, and by its plain language, unambiguously, includes activities that are not themselves market making.[50] 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 have the permitted activity incorporate more than pure market making.[51]

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[47] FSOC Study at 24.

[48] Proposal, Appendix A § IV.D.3.

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

[50] 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).

[51] *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.[52] For example, the market making-related permitted activity does not seem to recognize that arbitrage activities may at a minimum be market making-*related*. 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."[53] This blanket negative statement fails to recognize that many types of customer-focused transactions 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 a market making-related activity to the extent that it is driven by creating markets for customers tied to that price differential. As a result, the Agencies should recognize that arbitrage activity may fall within the market making-related permitted activity, and should not specifically ban arbitrage trading but instead monitor for impermissible patterns of activities through the metrics, compliance and examination tools.

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. As a part of customer service-oriented market making, banking entities need to be able to engage in this form of arbitrage trading.

Similarly, "market making-related" transactions should include transactions entered into for price-discovery purposes; for example, if Swap A and Swap B have some price correlation but neither trades regularly, a trader may execute a trade for price discovery purposes, using the price of Swap A to make an informed bid-ask market to a customer for Swap B.

Interaffiliate transactions are a critical component of risk management and swap dealer activity.

The Proposal is silent on the treatment of interaffiliate transactions, including transactions in swaps. Because interaffiliate transactions are not expressly covered by the statute and restrictions on these arrangements would not further the statutory purpose of the Volcker

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[52] 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 9.

[53] 76 Fed. Reg. at 68,871.

Rule, the Agencies should clarify that interaffiliate transactions are exempt from the proposed regulatory requirements. Interaffiliate swaps are a critical component of risk transfer and swap dealer activity and, in most cases, do not raise the types of concerns the Volcker Rule is meant to address. As such, interaffiliate swaps should be treated differently. In particular, 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 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. Interaffiliate transactions conducted to facilitate a permitted risk-mitigating hedging activity in swaps 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, 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. As we have explained at greater length,[54] interaffiliate transactions in swaps 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.

Interaffiliate transactions in swaps should be viewed as part of a coordinated activity for purposes of determining whether a banking entity falls within each permitted activity,

[54] 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).

including underwriting, market making and hedging. For example, if a market maker shifts swap positions that must be held as inventory to an affiliate that is better able to manage the risk, 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. There is no reason for the transactions between the market maker and the affiliate to be analyzed separately and potentially prohibited if no permitted activity applies. Similarly, 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.

To the extent the Agencies are concerned that interaffiliate transactions in swaps might be used to mask impermissible proprietary trading, that concern 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. If the Agencies do not exclude interaffiliate transactions, they must ensure that the market making-related and other permitted activities allow for such transactions.

The importance of interaffiliate transactions also supports the need for supervisory coordination in implementing the Volcker Rule. If multiple regulators are responsible for supervision, then there could be multiple views on the legality of a banking entity's interaffiliate transactions from the perspective of the affiliate supervised by the particular Agency. To avoid such legal uncertainty, we recommend that, as discussed further below,[55] the Agencies ensure that a single Agency have exclusive authority to interpret the Volcker Rule and the final rule regulations and that there be one exam report per banking entity with one set of findings and one regulatory voice to the relevant banking entity.

The Commission should not equate status as a "swap dealer" with market making activities under the Volcker Rule.

The Commodity Exchange Act ("**CEA**") defines the term "swap dealer" to include any person who "(i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps."[56] As required by Dodd-Frank, the Commission has proposed a rule to further define the term "swap dealer" but has not yet finalized it.[57] In the

[55] See the discussion beginning on page 40.

[56] 7 U.S.C. § 1a(49).

[57] *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).

Proposal, the Commission notes that it expects the final rule regarding swap dealers to provide guidance on the criteria for determining whether a person is engaging in market making, which would help determine whether that person is a swap dealer.[58] In Question 88.1, the Commission then asks to what extent it should incorporate into the Volcker Rule concepts regarding market making from this swap dealer definition rulemaking.[59]

Meeting the definition of "swap dealer" should not necessarily be equated with "market maker" activities under the Volcker Rule. For example, swap dealers, unlike market makers, are subject to a de minimis threshold pursuant to which an entity that "engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers" is exempt from designation as a dealer, in which case an entity that may very well be engaged in market making activities may not have registered as a swap dealer.[60] In short, while there may be some overlap between the market making definition under the Volcker Rule and the definition of swap dealer for purposes of swap dealer registration, the two terms were created for different purposes and should not be assumed to be the same.

The Proposal's implementation of the risk-mitigating hedging permitted activity is overly narrow and does not accord with the use of swaps as hedges or congressional intent to maintain the critical swap dealing function of banking entities.

The Agencies proposed an overly narrow risk-mitigating hedging permitted activity that fails to allow for all valid hedging. In permitting banking entities to engage in risk-mitigating hedging, Congress recognized the importance of hedging to financial stability and institutional safety and soundness. As the FSOC explained in its study, "[p]rudent risk management is at the core of both institution-specific safety and soundness, as well as macroprudential and financial stability."[61]

A narrow risk-mitigating hedging permitted activity 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. Accordingly, the FSOC stated that "[t]he Volcker Rule should not be applied in a way that interferes with a banking entity's ability to use risk-mitigating hedging."[62] The Proposal does not effectuate this goal. With respect to the Commission's interests in particular, the risk-mitigating hedging permitted activity is too narrow to allow swap dealers to engage in hedging transactions needed to offset the risks of swaps, or to enter into swaps as hedges for other swaps.

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[58] 77 Fed. Reg. at 8356.

[59] 77 Fed. Reg. at 8359.

[60] 7 U.S.C. § 1a(49)(D).

[61] FSOC Study at 21.

[62] FSOC Study at 21.

Hedging, particularly hedging the risks of swap activities, can be an exceedingly complex task. Valid hedges may not fit neatly into narrow, hard-coded criteria, as the Proposal currently requires. For example, the Proposal requires that risk-mitigating hedging not give rise to new, non-hedged risks at inception.[63] The requirement erroneously assumes that hedge positions decrease risk along all dimensions. To the contrary, hedging often reduces risk on one dimension but raises 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 swap 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 or other risk.

For example, any swap, security-based swap or futures contracts used as a hedge 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."[64] 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."[65] This does not fully reflect that the basis and counterparty credit risk may itself be significant. In fact, as we discuss above in the context of interdealer trading,[66] 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 Proposal also requires that any hedging transaction be "reasonably correlated" to the risk hedged and suggests that a hedge may be prohibited if it results in appreciable profits.[67] Some *bona fide* hedging transactions, however, may not meet a correlation statistic and could, over the duration of the hedge, generate profits for the banking entity. 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

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[63] Proposal § __.5(b)(2)(iv).

[64] 77 Fed. Reg. at 8361.

[65] 76 Fed. Reg. at 68,876.

[66] See the discussion beginning on page 16.

[67] Proposal § __.5(b)(2)(iii); 77 Fed. Reg. at 8361.

be appropriate, and a risk manager with knowledge of the financial markets may foresee that a specific instrument may usefully offset an extreme or previously unknown risk.

Accordingly, we believe the hedging permitted activity, rather than focusing on whether, in hindsight, the hedge seemed to be the best possible position, should focus upon the *purpose* of entering into the transaction. That is, the final rule should look at whether a hedge was entered into principally for hedging purposes as opposed to for speculative purposes. It is also improper to cast doubt on *bona fide* hedging transactions based on whether they might, over the duration of the hedge, generate profits. Any incidental profits generated by a hedge entered into principally for hedging purposes would be acceptable, and in fact would promote the safety and soundness of the banking entity. Indeed, the statute only requires that the hedging activity be "designed to reduce the specific risks"[68] of the position or holding; the Agencies should not go beyond the statute and limit activities that serve the fundamental purpose of hedging risk simply because they end up producing a financial gain.

We appreciate the Agencies' inclusion of anticipatory hedging within the exemption. However, the Agencies would drastically diminish the utility of this exemption by requiring that the anticipatory hedge not anticipate more than "slightly" the relevant specific risk.[69] Again, we would remind the Agencies that some revenue enhancement achieved through book management is a vital component to maintaining acceptable prices for customers. Appropriate policies, limits and examination metrics should be sufficient to assure that the hedging process does not hide impermissible proprietary trading.

In light of the above discussion, we believe 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. The Agencies should adopt a presumption that risk-mitigating activities are not subject to the prohibition on proprietary trading. The Proposal's hard-coded criteria should become 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.[70] As in the market making-related context, banking entities should be required to incorporate the guidance into policies and procedures to monitor the safety, soundness and appropriateness of hedging.[71] 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 currently allowed in the Proposal,[72] should be presumed to be appropriate hedges unless determined otherwise.

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

[69] 77 Fed. Reg. at 8361.

[70] For a more thorough discussion, see February 13 Prop Letter at A-62-A-64.

[71] For example, the risks of inappropriate positioning for the purpose of profiting from price changes can be addressed through policies and procedures, metrics and supervisory monitoring.

[72] *See* 77 Fed. Reg. at 8360-61.

Quantitative metrics should serve as signals to highlight opportunities for further discussion of the activities of the trading unit rather than as bright-line thresholds.

As stated above,[73] the Agencies should reorient the Proposal by recasting the hard-coded criteria in the permitted activities as guidance, which would be incorporated in policies and procedures overseen by the regulators through metrics and examinations. The appropriate role for quantitative metrics in this framework is as a method to highlight opportunities for further discussion of the activities of the trading units, rather than as a bright-line trigger for remedial action.

Some metrics (*e.g.*, risk factor sensitivities) may be more relevant to swap dealing than others, depending upon the particular instrument 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.

We agree with the FSOC[74] and the Proposal[75] 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. The Agencies should make such a determination based not on hard-coded thresholds for each metric, but by endeavoring to understand how metrics differ among banking entities, trading units, asset classes, activities and market conditions. 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."[76]

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."[77] Different banking entities may be structured differently, combining more or fewer activities into a single trading 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

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[73] See the discussion beginning on page 7.

[74] *See* FSOC Study at 37.

[75] *See* Proposal, Appendix A § I.

[76] FSOC Study at 37.

[77] FSOC Study at 37. 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 . . . Agencies [should] 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.

relevant to swaps. Metrics levels will also vary by type of activity—VaR values for cash equity trading may be different from VaR values 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.

We understand, as do the Agencies,[78] 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 undertake 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.[79]

The proposed metrics should be revised and the Commission should not require reporting of any metric that does not provide meaningful data for Commission-regulated instruments.

In Question 168.1, the Commission asks whether it should incorporate all of the required metrics into its rule. In Question 168.2, the Commission asks whether, if it reduces the number of required metrics, all covered banking entities should be required to comply with the reduced number of required metrics, regardless of size of the overall banking entity. As we discuss further below,[80] we support the Agencies' adopting one common final rule that would include all of the same metrics. However, we believe that a number of metrics should not be incorporated into the final rule or otherwise require revision, and that the removal of any metric unsuited to the swap market should not thereby increase the number of metrics that smaller entities are required to calculate.

As discussed in the February 13 Prop Letter, we believe that the following metrics are particularly problematic and should be removed in their entirety for all asset classes:

- **Spread Profit and Loss**: The Spread Profit and Loss ("**Spread P&L**") metric is defined as the "portion of Portfolio Profit and Loss that generally includes revenue generated by a trading unit from . . . charging a 'spread.'"[81] A

[78] 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." 76 Fed. Reg. at 68,883.

[79] *See* Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed Reg. 8,265 (Feb. 14, 2011) ("**Conformance Rule**").

[80] See the discussion beginning on page 41.

[81] 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.

meaningful measure for Spread P&L, as currently drafted, cannot be calculated in the absence of a continuous bid-ask spread, which simply does not exist in many of the swap markets regulated by the Commission. If the Commission nonetheless retains this metric, 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,[82] but should not bear the burden of proving that no bid-ask spread is widely disseminated or that the particular proxy used is best.

- **VaR Exceedance**: 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, the metric is unhelpful, is beyond the Agencies' statutory Volcker Rule mandate and should be removed.

- **Comprehensive Profit and Loss Attribution**: The Comprehensive Profit and Loss Attribution metric is defined as "an attribution analysis that divides the trading unit's Comprehensive Profit and Loss into the separate sources of risk and revenue that have caused any observed variation in Comprehensive Profit and Loss."[83] 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. To the extent it is not removed, the Commission must ensure it can be calculated by each institution in a way that reflects that institution's unique characteristics.

- **Pay-to-Receive Spread Ratio**: The 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."[84] As such, 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, and does not provide any additional information to the Agencies beyond what is available from other metrics.

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[82] *See* Proposal, Appendix A § IV.B.4.

[83] 77 Fed. Reg. at 8438.

[84] *See* Proposal, Appendix A § IV.E.1.

The following metric, though potentially useful for other asset classes, is not relevant to swaps and should not be required to be calculated for swaps:

- **Inventory Aging:** 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."[85] 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 swap markets. Swap contracts are bilateral transactions that, for example, are generally held to maturity, allowing clients to hedge term funding risk. Where a swap transaction is terminated early, it is done so at the request of the client. As such the concept of aging of specific swap transactions will yield information only around the behavior of clients whose termination decisions might be based on a number of idiosyncratic factors. Our view is consistent with 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."[86] As a result, the Commission should make clear that the Inventory Aging metric does not have to be calculated for swaps.[87]

Finally, a number of metrics are useful in theory but need specific alterations to achieve their purpose:

- **Customer-Facing Trade Ratio:** The Customer-Facing Trade Ratio metric 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."[88] The metric, as currently formulated, is flawed for three main reasons:
  - 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, swap dealers entering into swaps with customers may often enter

[85] Proposal, Appendix A § IV.D.2.

[86] FSOC Study at 40.

[87] 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.

[88] Proposal, Appendix A § IV.D.3.

into several hedge trades in the cash market. 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. The Agencies recognize this in Appendix B: "In the case of a derivatives market maker that engages in dynamic hedging, the number of noncustomer transactions significantly outweighs the number of customer transactions, as the derivatives market maker must constantly enter into transactions to appropriately manage its retained principal positions and risks as market prices for the positions and risks move and additional transactions with customers change the risk profile of the market maker's retained principal positions."[89] 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.

- Second, 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 CEA 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 any affiliate thereof."[90] The presumption that a registered entity or affiliate by definition is not a customer is particularly problematic and contradicts informative statements made by the Agencies elsewhere in the Proposal. In Appendix B, the Commission notes 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 maker's intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services."[91] 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

[89] Proposal, Appendix B § III.A.

[90] Proposal, Appendix A § IV.D.3.

[91] Proposal, Appendix B § III.A.

‘counterparty.’”[92] 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, the individual tagging of trades as “customer” or “non-customer” trades will be extremely 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. 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 Commission should recognize that every counterparty of a *bona fide* market maker is in fact a customer. Due to these flaws, we believe that the Customer-Facing Trade Ratio, in its current form, is unworkable. Instead, the Commission could require each institution to provide the Agencies with information on its activities by class of counterparty, such as by dealer vs. non-dealer.

- **Inventory Risk Turnover:** 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, that is turned over by a trading unit over a specified period of time.”[93] This reliance on measuring risk through the Risk Factor Sensitivities is appropriate. However, because 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 be required to calculate only the Inventory Risk Turnover with respect to the principal measure of directional risk for each trading unit.[94]

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[92] 76 Fed. Reg. at 68,890 n.199.

[93] Proposal, Appendix A § IV.D.1.

[94] On a technical level, the definition of “Inventory Risk Turnover” may result in a measurement that does not adequately reflect risk turnover because 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.

"Trading unit" should not be defined too narrowly. It should be defined at a level that presents the unit's activities in the context of the whole and that accounts for the scope of the market in which the trading unit operates.

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 compliance requirements on a trading unit basis.[95] "Trading unit" is a multi-level definition.[96] 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.'"[97] 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.[98] 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."[99] These trading units, in turn, are rolled up to create a trading unit out of all trading operations of the banking entity.[100] 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.

However, we believe that the Agencies must ensure that trading unit is not defined so narrowly that it captures only a portion of a unit's activities rather than the activity as a whole. The concept of "trading unit" should account for the scope of the market in which the trading unit operates, which may be global for many of the products within the Commission's purview. If trading units are defined too narrowly, then trading activities that are connected could appear to be unrelated. As a result, reported quantitative metrics will be overly volatile

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[95] *See* Proposal § __.7(a).

[96] *See* Proposal, Appendix A § II.

[97] *Id.* § II and n.1.

[98] *Id.* § II.

[99] *See id.* at n.2.

[100] *See id.* § II.

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 narrowness for a "trading unit" is likely to depend on the structure of the individual banking entity, activity and involved asset classes. Choosing a level that is too narrow would be particularly problematic in the context of commodities markets. In these markets, market makers often trade with counterparties in a specific location, but the hedges may be executed at an entirely different location. If the trading unit is defined too narrowly, therefore, an activity that is actually permitted may appear to be prohibited. Ascertaining the right level of narrowness is a difficult determination that will require the Agencies to learn about individual banking entities, their activities and the differences among asset classes, which can be accomplished during the statutory conformance period.

To ensure that "trading unit" is not defined at too narrow 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 narrowness, we believe the appropriate level may be either the level at which banking entities set budgets, risk metrics and other mandates or the level 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.

The Proposal's definition of "commodity pool" is overly broad.

In Question 218.1, the Commission asks whether the definition of "commodity pools," which is included in the definition of "covered fund," is too broad. As stated in our February 13 Funds Letter, this definition is overbroad and exceeds the scope of the statutory term. To better align with the statutory framework, we recommend that the term "similar commodity pool" be defined as any commodity pool, as defined in the CEA, that satisfies all of the following conditions: (a) it is engaged primarily in trading commodity interests; (b) it does not make a public offering of its securities; (c) its securities are beneficially owned by no more than 100 persons or exclusively by qualified purchasers (as defined in the Investment Company Act of 1940 (the "**1940 Act**")); (d) it has all of the characteristics of a hedge fund or private equity fund as commonly understood (*i.e.*, as set forth in Annex B of our February 13 Funds Letter); and (e) it is not an Excluded Entity,[101] an Exempt Fund[102] or an exchange-traded fund ("**ETF**").

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[101] Excluded Entities include wholly owned subsidiaries, joint ventures, acquisition vehicles, financial market utilities, SEC-registered investment companies, business development companies and any other issuer designated as an "excluded entity" by rule or order of the Agency that is the banking entity's primary federal financial regulator.

[102] Exempt Funds include any issuer that would be an investment company under the 1940 Act, but for qualifying for an exemption other than under Sections 3(c)(1) or 3(c)(7) of that Act.

By designating all commodity pools as "similar funds," the Agencies dramatically expanded the range of entities treated as covered funds under the Volcker Rule. The Agencies explained that their intent in designating all commodity pools as similar funds was to capture entities that "are generally managed and structured similar to a covered fund, except that they are not generally subject to the federal securities laws due to the instruments in which they invest."[103] The Dodd-Frank Act amended the CEA to define a "commodity pool" as "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests."[104] The term "commodity interest" is defined to include contracts for the purchase or sale of a commodity for future delivery; security futures products; swaps; retail foreign exchange transactions; retail commodity transactions, commodity options; and leverage transactions.[105]

In light of those sweeping definitions, there is a serious legal risk that any company that buys or sells even a minimal amount of commodity interests, even for hedging purposes, could be characterized as "trading in commodity interests."[106] Therefore, absent clarification from the Agencies, the term "commodity pool" could sweep in virtually any subsidiary or affiliate in a banking group that buys or sells even a minimal amount of commodity interests for hedging purposes. This would typically include all bank holding companies ("**BHCs**"), other depository institution holding companies ("**DIHCs**"), insured depository institutions ("**IDIs**"), foreign banking organizations that are treated as BHCs ("**FBOs**"), SEC-registered broker-dealers, Exempt Funds, or even SEC-registered investment companies. There is a serious legal risk that all would be commodity pools as defined by the CEA, absent further clarification.

The Act should not be interpreted to authorize the Agencies to sweep in such a broad range of subsidiaries or affiliates under their "similar funds" designation authority. For one thing, that would lead to results that Congress could not possibly have intended. For example, if an IDI subsidiary were treated as a covered fund because it falls within the definition of "commodity pool," BHCs and other DIHCs would immediately upon the effective date of the Volcker Rule be prohibited from acting as a source of strength for their subsidiary IDIs in the form of providing extensions of credit to or entering into a transaction that reduces the credit risks of an IDI, even if the transactions are fully secured by U.S. government securities or cash collateral. BHCs and other DIHCs would also be required to divest all of their ownership interests in their IDI subsidiaries by the end of the conformance period because an investment in

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[103] *See* 76 Fed. Reg. at 68,897.

[104] *See* 7 U.S.C. § 1a(10).

[105] *See* 7 U.S.C. § 1a(10)(A)(i)-(iv).

[106] *See, e.g.*, CFTC Letter No. 98-18 (Mar. 12, 1998) ("[T]here is currently no exception to the obligation to register as a CPO or CTA based solely on the fact that the pool makes…only *de minimis* investments in the futures markets."); *see also* CFTC, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (Feb. 10, 2012), *available at* http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf (noting that "one swap contract would be enough to trigger the [commodity pool operator] registration requirement").

such a company could not be conformed under any of the "permitted activities" exemptions in Subsection (d)(1) of the statute. They would also be subject to a similar prohibition and divesture requirement with respect to any of their other subsidiaries or affiliates that could be characterized as trading in commodity interests because they buy or sell a minimal amount of commodity interests, including for hedging purposes.

The designation of all commodity pools as covered funds would even appear to require BHCs to divest all of their non-fund subsidiaries and affiliates by the end of the conformance period, while permitting them to retain 3% of any of their subsidiaries that are genuine hedge funds or private equity funds, subject to certain conditions. This result follows from the fact that investments in non-fund subsidiaries, including subsidiary IDIs, would not be able to qualify for any of the "permitted activities" exemptions in the Proposal. Rather than increase the safety, soundness and stability of the U.S. and global financial system, the Proposal could therefore destabilize it. Congress could not possibly have intended such a result.

In addition, the statute does not give the Agencies unfettered discretion to designate all commodity pools as "covered funds." The statute only authorizes them to include within the term "covered funds" those commodity pools that are not captured by the General Definition[107] of the terms "hedge fund" and "private equity fund," but are similar to the sorts of funds that are captured by the General Definition as properly construed. The General Definition should be construed as any company that (a) would be an investment company under the 1940 Act but for Sections 3(c)(1) or 3(c)(7) of that Act, (b) has all of the characteristics of a hedge fund or private equity fund as commonly understood (*i.e.*, as set forth in Annex B of our February 13 Funds Letter), and (c) is not an Excluded Entity.

In order to be an investment company under the 1940 Act, an issuer must generally either (i) be "engaged primarily" in the business of investing, reinvesting or trading in securities or (ii) be engaged in the business of investing, reinvesting, owning, holding or trading in securities and own investment securities having a value exceeding 40% of the total value of the issuer's assets.[108] In order to qualify for an exemption under Sections 3(c)(1) or 3(c)(7) of the 1940 Act, an issuer must not make a public offering of its securities, and its securities must be held by no more than 100 persons or exclusively by persons that are "qualified purchasers," as defined in Section 2(a)(51) of the Act. Funds that rely on those exemptions are unregulated in the sense that, although their managers may be subject to the Investment Advisers Act, the funds themselves have no limits on the securities they may buy, the liquidity of their interests, borrowing or diversification. Nor are the operations of the fund subject to substantive requirements, including limitations on fees, redemptions or valuation.[109] In fact, hedge funds

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[107] General Definition refers to the portion of the Volcker Rule that defines a "hedge fund" and "private equity fund" generally as any issuer that would be an investment company under the 1940 Act, but for Sections 3(c)(1) or 3(c)(7) of that Act.

[108] *See* 1940 Act, § 3(a)(1)(A) and (C).

[109] We note that under the SEC's Form PF, "hedge fund" and "private equity fund" are defined as "private funds," defined in turn to be any issuer that would be an investment company but for section 3(c)(1) or 3(c)(7). *See* Form PF: Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and (…continued)

and private equity funds as commonly understood are limited in their activities solely by what investors may be willing to accept.

Thus, in order for a commodity pool to be similar to an issuer that falls within the general definition of the terms "hedge fund" or "private equity fund," it would need to satisfy all of the conditions described above. These conditions are all necessary to confine the range of "commodity pools" treated as covered funds to those that are genuinely similar to hedge funds or private equity funds. They properly exclude ordinary business entities that are not pooled investment vehicles, but may nevertheless use swaps, futures contracts or other commodity interests, for example, to hedge a fixed rate loan, foreign exchange exposure or some other exposure or to facilitate capital investment in conjunction with a line of business.

The Commission 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.

The statutory Volcker Rule restricts proprietary trading in any security, futures contract or derivative.[110] None of these terms are defined in the statute. The Proposal, however, uses a broad definition of "derivative" that incorporates instruments that do not belong within the scope of the Volcker Rule. In so doing, the Agencies have exceeded their congressional mandate and threaten to harm markets that Congress sought to protect.

Commodity Forwards

The statutory text of the Volcker Rule does not subject forwards to its restrictions. The Proposal, however, includes within the definition of "derivative" purchases or sales of nonfinancial commodities for deferred shipment or delivery that are intended to be physically settled.[111]

Commodity forwards are not appropriately viewed as "derivatives," but instead as contracts for purchase of specific commodities to be delivered at a future date.[112] In recognition of this fact, Congress explicitly excluded these contracts from regulation as swaps.[113] As the

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(continued…)

Commodity Trading Advisors, SEC 2048 (12-11). Among the conditions of these exemptions is that an issuer not be "making and does not presently propose to make a public offering of its securities." Thus, the SEC has itself acknowledged that a fund that is publicly offered and subject to substantive regulation is not a "hedge fund" or "private equity fund."

[110] Bank Holding Company Act § 13(h)(4) (as added by Dodd Frank § 619).

[111] *See* Proposal § __.2(l).

[112] 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).

[113] *See* 7 U.S.C. § 1a(47) (as amended by Dodd-Frank § 721).

SEC and Commission noted in proposed rules to implement Title VII: "Forward contracts with respect to nonfinancial commodities are commercial merchandising transactions. The primary purpose of the contract is to transfer ownership of the commodity and not to transfer solely its price risk."[114] In addition, while earlier drafts of the Volcker Rule explicitly included "commodities," the removal of that term from the final Volcker Rule indicates the Agencies do not have statutory authority to subject commodity forwards to proprietary trading restrictions.

Therefore, the statutory text and legislative history make clear that Congress did not intend for commodity forwards to be included in the definition of "derivative" and thereby subject to the restrictions of the Volcker Rule. Moreover, end users commonly use commodity forwards to manage the risks associated with their commodity-related businesses. Subjecting commodity forwards to the limitations of the Volcker Rule would restrict commodity transactions that are excluded from the scope of the Volcker Rule and that are central to the U.S. economy. Accordingly, the Commission should exclude these instruments from restrictions on proprietary trading.

Foreign Exchange Swaps and Forwards

In the Proposal, the Agencies have explicitly included foreign exchange swaps and forwards within the definition of "derivative."[115] 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[116] explicitly permits the Treasury Secretary to exclude foreign exchange swaps and forwards from regulation as "swaps" for most Title VII purposes.[117] The Treasury Secretary has proposed doing so,[118] 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."[119]

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[114] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818, 29,828 (proposed May 23, 2011).

[115] Proposal § __.2(l)(i)(C).

[116] *See* Commodity Exchange Act § 1a(47)(E) (as amended by Dodd-Frank § 721).

[117] 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.

[118] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25,774 (proposed May 5, 2011).

[119] *Id.* at 25,776.

Just as Treasury has proposed excluding foreign exchange swaps and forwards from regulation as swaps under Title VII, the Commission should exclude these instruments from the definition of derivative in the Volcker Rule.[120] The only "derivative" characteristic that distinguishes forwards 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, excluding foreign exchange swaps and forwards from the definition of "derivative" is consistent with congressional intent and the policy goals of the Volcker Rule.

In addition, the Proposal notably excludes spot foreign exchange transactions from the definition of "covered financial position"[121] even though it explicitly includes foreign exchange swaps and forwards. Consequently, the Volcker Rule regulations would significantly impede typical foreign exchange activity and, as a result, adversely impact liquidity in this well-established market. Critically, these effects will not be limited to 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 would also negatively impact liquidity in the spot market, further hurting the end user.[122] 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. Accordingly, to give effect to the exclusion for spot foreign exchange, the Commission should exclude foreign exchange swaps and forwards.

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

Trading in derivatives on permitted government obligations should be included in the government obligations permitted activity. Banking entities trade futures and swaps on government obligations as part of their activities in the underlying obligation. A banking entity, for example, 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

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[120] Congress could not have intended for "derivative" to be construed so broadly in the statutory Volcker Rule as to encompass all forms of "derivative," because the statute lists commodity futures and options on a security—also derivatives—as separate categories.

[121] Proposal § __.3(b)(3)(ii)(C).

[122] Market makers manage their inventories in currencies across delivery dates.

activity. The government obligations permitted activity, however, does not include trading in futures and swaps on these instruments. 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.

The Commission should exempt from the "trading account" all activities, such as repurchase agreements and transactions related to such agreements, that "are not based on expected or anticipated movements in asset prices."

In the Proposal, the Agencies exclude repurchase transactions ("**repos**") from the trading account. In choosing to exclude repos, the Agencies explained these "positions . . . are not based on expected or anticipated movements in asset prices,"[123] essentially determining that repos are more akin to funding transactions like lending and deposit-taking.[124] As an initial matter, we support the exclusion. However, we note that some commenters have argued that repos should not be excluded from the definition of trading account. They assert that there is no statutory basis for the exclusion. We respectfully disagree.

First, these agreements are not included in the list of instruments and agreements covered by the proprietary trading definition in the statute. Second, they are not a means through which banking entities effect the short-term sale of securities or seek to profit from short-term price movements in those securities. Rather, as acknowledged in the Proposal, repos are primarily a means of financing; they function economically as collateralized loans, which are not subject to the Volcker Rule. Indeed, banking entities use repos to finance a wide variety of activities, including dealing in U.S. Treasuries and in other markets. Repos are mechanisms to facilitate the efficient use of collateral and are essential for banking entities in financing their core activities. Limiting their use by subjecting them to the Volcker Rule would impair these activities. We also believe this logic supports excluding not just repos, but all transactions that are not based on expected or anticipated movements in asset prices. These types of asset purchases and sales are not the type of transaction that should be included in the definition of trading account.

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[123] 77 Fed. Reg. at 8347.

[124] We believe that the Proposal's exclusion is meant to incorporate all forms of repo currently engaged in by banking entities. However, the Commission should be more explicit. For example, while we believe that the current repo exclusion incorporates open-dated repo contracts in addition to term repo (including term repo that uses a collateral schedule), overnight repo and repo to maturity, the Commission should explicitly incorporate all of these types of repo transactions in the exclusion. The Commission should also 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 a 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.

For example, fully collateralized swap transactions, while legally distinct from lending arrangements, serve as funding transactions and are economically similar to repos 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 from the trading account definition should also encompass other transactions related to providing funding, such as transactions in asset swaps and foreign exchange swaps (if not excluded from the definition of derivative). 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.

To allow for such activity, it is critical that related transactions allowing the activity to occur are also excluded from the trading account. For example, in Question 30.2, the Commission notes that only the actual repo agreement is excluded from the definition of "trading account" under the Proposal, and asks whether the exclusion should be expanded to include the collateral or position that is being financed by the repo arrangement. While we believe the definition of repo used in the Proposal captures typical transactions, 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. For the same reasons, the exception for related transactions should extend to the other activities described above that should be excluded from the trading account.

The Commission should confirm that "clear, timely and effective disclosure" to mitigate conflicts of interest can take the form of either periodic or specific disclosures regarding transactions.

The statutory Volcker Rule provides a backstop that prohibits an otherwise permitted activity if it would "involve or result in a material conflict of interest . . . between the banking entity and its clients, customers, or counterparties."[125] The Commission's Proposal recognizes that one way in which a banking entity can mitigate potential conflicts of interest is through disclosure.[126] We agree that disclosure is key to mitigating conflicts of interest and its inclusion in the rule for this purpose is appropriate. A principal purchase and sales transaction inherently involves parties whose interests, while aligned in many ways, differ in some; disclosure has been recognized to be a suitable means of addressing any perceived conflict in these circumstances.

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

[126] Proposal § __.8(b)(1).

Disclosure must be effective to respond to and cure conflicts of interest. In that vein, requiring trade-by-trade disclosures of certain ordinary course conflicts would be too burdensome for banking entities to administer and, more importantly, unnecessary in light of most clients' prior understanding of the nature of a banking entity's role as market maker. In these situations, 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 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.[127] 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.

The statutory text of the Volcker Rule does not mandate the form that any disclosures must take. Accordingly, the Proposal should confirm that trading relationship-level disclosures can mitigate effectively the potential ordinary course conflicts of interest and provide that trades pursuant to such disclosures would not be considered prohibited transactions. That is, 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 would be 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, the Agencies should articulate a clearly defined standard for when transaction-specific disclosure is needed. Specifically, the Agencies should specify a predefined set of transactions, such as Complex Structured Finance Transactions ("**CSFTs**"),[128] as the types of transactions for which

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[127] 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. *See* 76 Fed. Reg. at 68,893.

[128] 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).

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.

As the Commission intimated, coordination between the Agencies is critical for effective implementation of the Volcker Rule; the Board should have exclusive authority to interpret the Volcker Rule and the final rules, and the Agencies should coordinate examination and enforcement where appropriate.

In Question 8.1, the Commission asks what method it and the other regulators should use to coordinate the allocation of supervisory responsibility. As stated in the February 13 Prop Letter,[129] we recommend that: (i) the Board 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 engage in a coordinated examination of such banking entity under the Volcker Rule; and (iii) an enforcement action under the Volcker Rule 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.

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 Commission-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, the Commission and the SEC. The problem is magnified for all banking entity families that, as allowed by the Proposal, institute enterprise-wide compliance regimes.[130]

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

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[129] February 13 Prop Letter at A-116-A-117.

[130] *See* Proposal, Appendix C § I.D.

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.

Finally, if multiple Agencies are responsible for interpreting the rule, then banking entities will feel they must abide by the most restrictive interpretation in order to avoid adverse enforcement action. For example, even though one Agency may decide to adopt a more relaxed standard for a particular requirement, the regulated banking entity will feel compelled to adhere to the most restrictive standard that satisfies all of the Agencies' interpretations. Such an approach would lead to unintended adverse consequences, in the aggregate producing a set of rigid restrictions that no single Agency intended.

Accordingly, we believe that a single Agency should have exclusive authority to interpret the Volcker Rule and the final rule regulations. 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. 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. Such a role would be consistent with Chairman Gensler's 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."[131]

With respect to examinations and enforcement, 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. This arrangement would be consistent with the Agencies' expressed desire to coordinate enforcement so as to avoid inconsistency and uncertainty. Thus, 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. 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.

The Commission should join with the other Agencies in one common final rule, even if elements of that common rule are inapplicable to entities under the Commission's jurisdiction.

Several of the Commission's questions request comment on whether the Commission should retain elements of the common Proposal that are not relevant to the

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[131] *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) (Statement of Commission Chairman Gary Gensler).

Commission's direct oversight of entities under its jurisdiction.[132] For example, Question 87.1 asks about references in the market making-related permitted activity to registration of SEC-registered broker-dealers and security-based swap dealers. In addition, Federal Reserve Governor Tarullo recently suggested during a Senate Banking Committee hearing that there would be two different sets of Volcker rules: one issued by the three prudential regulators (*i.e.*, the Federal Reserve, the FDIC and the OCC) and one by the two market regulators (*i.e.*, the SEC and the Commission).[133]

We strongly support the Agencies joining in one common rule and adopting release, even though some elements of that rule or adopting release might not be applicable to every Agency that adopts it. We believe that having one common rule and adopting release is critical to ensure regulatory certainty and consistency. Without such a common rule and adopting release, we worry that the Agencies and market participants may read too much into why a particular provision or element of guidance was deleted from or kept in the specific rule of one Agency or group of Agencies, adding unnecessary complexity and lack of clarity to an already complicated rule.

The Agencies should repropose Volcker Rule regulations before finalizing them.

We believe the Agencies should repropose the Volcker Rule regulations before finalizing them. Reproposal is necessary for several reasons:

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 chance to review the necessary changes and cost-benefit analysis.[134]

Second, in posing more than 1,300 questions, the Agencies have revealed the wide array of open issues in the Proposal. The Agencies have received 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 provide numerous

[132] *See* Questions 14.1, 30.1, 64.1, 87.1, and 177.1 in the Proposal.

[133] *See International Harmonization of Wall Street Reform: Hearing Before S. Comm. on Banking, Housing & Urban Affairs*, 112th Cong. (Mar. 22, 2012) (Statement of Daniel K. Tarullo, Member, Federal Reserve System Bd. of Governors).

[134] *See Chamber of Commerce v. SEC*, 443 F.3d 890, 903-05 (D.C. Cir. 2006) (holding SEC needed to provide additional notice and comment when it readopted a rule relying on a handful of materials that had not been exposed to public comment); *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).

suggestions and explain to the Agencies the unintended consequences of elements of the Proposal. Incorporating these comments into an already complex and flawed rule may lead to further unintended consequences and is likely to result in a proposal sufficiently different such 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.

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We thank the Commission for its 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; or any of the organizations listed below.

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

ANNEX A

About the Signatories

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. Learn more at www.aba.com.

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs. *See* the Financial Services Roundtable's web page at http://www.fsround.org.

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.