

Royal Bank of Canada

February 13, 2012

Board of Governors of the Federal Reserve System
Attention: Jennifer J. Johnson, Secretary
20th Street and Constitution Avenue, NW
Washington, DC 20551

Federal Deposit Insurance Corporation
Attention: Robert E. Feldman,
Executive Secretary
550 17th Street, NW
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Securities and Exchange Commission
Attention: Elizabeth M. Murphy, Secretary
100 F Street, NE
Washington, DC 20549

Commodity Futures Trading Commission
Attention: David A. Stawick, Secretary
3 Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

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

Ladies and Gentlemen:

Royal Bank of Canada ("RBC") appreciates the opportunity to provide our comments to the Securities and Exchange Commission (the "SEC"), Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC"), and the Commodity Futures Trading Commission (the "CFTC," and collectively with the SEC, the OCC, the Federal Reserve and the FDIC, the "Agencies") in response to the joint notice of proposed rulemaking (the "Notice") relating to the proposed rule (the "Proposed Rule") implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1] The Dodd-Frank Act incorporates

[1] The Notice was initially issued in October 2011 by four of the five Agencies and published in the Federal Register in November. *See* Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011). On January 13, 2012, the CFTC issued its own version of the Proposed Rule pertaining to institutions for which it is the primary federal financial regulator. The CFTC's notice is expected to be published in the Federal Register later in February 2012.

Section 619 as new Section 13 ("Section 13," the "Legislation" or the "Volcker Legislation") of the Bank Holding Company Act of 1956 (the "BHC Act"). Subject to certain exemptions for permitted activities, Section 13 generally prohibits banking entities from engaging in "proprietary trading" and from acquiring or retaining any ownership interest in, or sponsoring a "hedge fund," a "private equity fund," or a "similar fund" (collectively, a "covered fund").

Introduction

RBC and its subsidiaries provide diversified global financial services and products, including personal and commercial banking, wealth management services, corporate and investment banking, property, casualty and life insurance, and transaction processing services to clients worldwide. RBC affiliates have been active participants in the U.S. financial system since the establishment of RBC's first agency office in the United States in 1899. We have a strong presence in the United States, providing services to U.S. consumers and institutional and corporate clients in 45 states. RBC operates in the United States as a foreign banking organization that is a bank holding company and a financial holding company under the BHC Act. RBC's U.S.-regulated affiliates are supervised by the Agencies and various state regulators and self-regulatory organizations. Our global activities, including our activities in the U.S., are supervised by our home regulator, the Office of the Superintendent for Financial Institutions ("OSFI"). Consequently, RBC understands, appreciates and supports the vital role that rigorous prudential regulation and supervisory oversight play in ensuring the stability of financial systems and market participants. We note also the important role that foreign banking entities play in developing the depth and liquidity of U.S. financial markets. For example, the Institute of International Bankers (the "IIB"), of which we are a member, has noted that, in the aggregate, its members' U.S. operations hold approximately $5 trillion in assets and provide 25% of all commercial and industrial bank loans made in the United States.

Structure of this Submission

We have organized this submission in a manner that provides the Agencies with an overview of our key messages, set forth in an Executive Summary. The Executive Summary is followed by a Table of Contents identifying the substantive topics addressed in our submission which are arranged into sections and appendices. The appendices address those sections that we believe require a more detailed discussion of market dynamics and practices, and the Proposed Rule's impact thereon.

Executive Summary

RBC supports the goals of financial reform and the objectives underlying the Volcker Legislation, which we understand to be the promotion of the safety and soundness of the U.S. financial system and the protection of U.S. taxpayers. We acknowledge the Agencies' hard work and the challenges they faced in developing regulations to implement the Legislation. We submit, however, that in many instances the Proposed

Rule is inconsistent with, or otherwise does not fully capture, Congressional intent, and will not advance the objectives underlying the Legislation. Our key messages are summarized below.

Extraterritorial Overreach

We share many of the same concerns as U.S. banking entities with respect to the impact of the Proposed Rule on our U.S. operations and clients (*e.g.*, it will unnecessarily restrict certain activities essential to the stability of U.S. financial markets such as market making, hedging and liquidity management), as expressed in the Securities Industry and Financial Markets Association's ("SIFMA") related comment letters. We are deeply troubled, however, by the Proposed Rule's extraterritorial impact on financial markets and operations of foreign banking organizations outside of the United States, including its impact on U.S. investors and borrowers seeking access to foreign markets.

We believe that the extraterritorial scope of the Proposed Rule is inconsistent with legislative intent and longstanding principles of international regulatory comity. By extending its basic principal trading prohibitions to non-U.S. banking entities where there is any U.S. nexus, the Proposed Rule improperly attempts to regulate foreign institutions and their foreign transactions, and disregards home country authority/supervision without protecting the stability of the U.S. financial system or benefitting U.S. taxpayers In this regard, our comment letter should be read in conjunction with the related comment letters of the IIB and Allen & Overy LLP (in addition to the other comment letters referenced herein).

Solely-Outside-the-U.S.

The "solely-outside-the-U.S." exemption should focus on the situs of risk-taking principal activity, and not on whether a transaction may involve a U.S. counterparty, U.S.-based personnel, or a U.S. execution facility. This approach would align with Congress' intent to protect U.S. taxpayers and the stability of the U.S. financial system without intruding into foreign business activities that are regulated by foreign authorities. By minimizing such intrusion, the Agencies could also make positive steps toward ensuring the health and stability of the U.S. financial system. Today, foreign banking entities provide liquidity to U.S. markets in significant ways, including through transacting with U.S. counterparties, trading over U.S. execution facilities and employing personnel in the U.S. to carry out and support these legitimate business activities. The Proposed Rule, as currently drafted, surely will lead a number of foreign banking organizations to modify their businesses in a way that removes liquidity and jobs from the U.S.

Liquidity Management

The exclusion of liquidity management activities from the definition of "trading account" is appropriate and very much needed. However, "liquidity management" is but a component of a corporate treasury function, and the exclusion does not sufficiently

encompass the scope of activities that banks undertake in order to manage their assets and liabilities. Unwarranted limitations on banking entities' asset liability management abilities would conflict with their obligations to maintain the safety and soundness of their operations. Foreign banking entities, for example, already at a competitive disadvantage relative to U.S. banking entities with respect to obtaining U.S. dollar liquidity, would be significantly hampered in effectively managing their U.S. dollar balance sheet(s) under the Proposed Rule. Such a constraint would render foreign banks less able to service U.S. borrowers.

Separately, certain foreign banking organizations would find themselves subject to conflicting regulatory frameworks if the definition of liquidity management is limited to managing "near-term cash needs." For example, RBC is subject to OSFI regulation that includes liquidity management requirements for meeting actual, expected and potential cash obligations over a specified time horizon. Activity conducted by RBC to meet these requirements may not comport with the U.S. view of "near term cash needs."

Market-Making and Related Activities

In describing the scope of this permitted activity, the Proposed Rule assumes that all market-making activities occur within an equity-like market structure, and agency-based dynamic. However, market-making activities in the largest markets - the fixed income markets - operate on a principal-to-principal dynamic. In order to meet customer demand and provide market liquidity, banking entities must remain able to transact as principal.

The Proposed Rule fails to fully consider how U.S. (and global) markets operate, and the fundamental role such markets play in ensuring a healthy economy. Instead of meeting Congress' objectives, the Proposed Rule threatens to harm the U.S. financial system and U.S. taxpayers in a ripple effect arising from the contraction of fixed income markets. The scope of permitted market making activity must be expanded to (i) better accommodate the critical principal commitment involved in market-making in fixed income and other less liquid markets and (ii) give full effect to the exemption for market-making "related" activities. Any concerns that banking entities would, as a result, engage in speculative proprietary trading would be addressed and allayed by other contemporaneous reform initiatives. For example, based on carefully crafted capital and liquidity requirements, Basel III implementation will provide laddered disincentives to holding positions as principal.

Trading on Behalf of Customers

Although the exemption for trading on behalf of customers allows for riskless principal transactions, it should be expanded to include principal risk-taking to support customer-driven transactions where there is no ready counterparty. For example, customer facilitation or block positioning transactions in which banks take on positions as principal should be permitted. It should be noted that the safe and sound operation of foreign banking organizations, including with respect to their trading- and funds-related

activities, will be enhanced by Basel III,[2] which will impose related capital and liquidity requirements in connection with such activity.

Underwriting

This exemption should explicitly authorize certain forms of offerings (e.g., Rule 144A, Regulation S, transactions on behalf of selling shareholders and sales of debt securities acquired in replacement of bridge loans) as permitted underwriting activities as they are "distributions" of securities. In addition, the Agencies should extend the exemption to allow principal positions in connection with activities that are relevant to completing successful transactions for issuers, including positions acquired via overallotments, naked syndicate shorts and unsold allotments.

Risk-Mitigating Hedging

This exemption takes a transaction-by-transaction approach to identifying hedges, even in allowing portfolio hedging, in that it requires each hedge to be reasonably correlated to one or more current risk exposures and does not give rise to new risks for the banking entity. Such an approach is impractical and generally not reflective of how risk is viewed or managed by banking entities. The exemption should approach risk management from an enterprise perspective, focusing on overall aggregate firm risk. This would provide banking entities the flexibility to pursue appropriate hedging strategies for managing the trading risk profile of the institution.

Sovereign Securities

The exclusion allowing proprietary trading in U.S. government, state and municipal securities should not be limited only to U.S. "sovereign" obligations. Our primary concern with the limited scope of this exemption relates to its impact upon (i) banking entities' U.S. operations, activities, safety and soundness and, therefore, (ii) U.S. and global financial markets. Thus far, regulators from Canada, Japan, the United Kingdom and the European Union have written to the Agencies, explaining that such limited scope would undermine the liquidity of government securities markets outside the U.S., impede the ability of foreign banks to manage their liquidity and funding needs and destabilize global financial markets.[3] We strongly urge the Agencies to develop and adopt an

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[2] "Basel III" refers to the framework set forth in two documents initially published by the Basel Committee on Banking Supervision on December 16, 2010: *Basel III: A global regulatory framework for more resilient banks and banking systems* (revised June 2011) and *Basel III: International framework for liquidity risk measurement, standards and monitoring*.

[3] *See, e.g.*, Office of the Superintendent of Financial Institutions Canada ("OSFI") Volcker Rule Comment Letter, Dec. 28, 2011 (the "OSFI Letter"); Government of Japan Financial Services Agency/Bank of Japan Volcker Rule Comment Letter, Dec. 28, 2011 (the "FSA/BOJ Letter"); Letter from George Osborne, Chancellor of the Exchequer, HM Treasury (U.K.), to Ben Bernanke, Bd. of Governors of the Fed. Reserve Sys. (Jan. 23, 2012) (on file with Bd. of Governors of the Fed. Reserve Sys.); Letter from Michel Barnier, European Commissioner for Internal Market and Services, to the Agencies, Feb. 8, 2012.

exception for trading in Canadian and other non-U.S. government securities. The exclusion for trading in sovereign obligations also should be extended to government-related derivatives, and state and municipal agency securities, including tender option bonds.

Funds Prohibitions

The definition of "covered fund" should be modified, in part, to exclude securitization conduit vehicles, Canadian mutual funds and public welfare funds so that banking entities may continue to invest in, or sponsor, these types of entities. Such a modification will also allow banks and their subsidiaries and affiliates to continue creating and selling asset-backed securities as well as acting as a financial intermediary and facilitating the asset securitization process. The exclusion of covered funds from the definition of "banking entity" should be clarified to exclude all covered funds in Subpart C of the Proposed Rule, and not just those sponsored or held by banking organizations pursuant to the authority granted in Section _.11. In addition, the provisions of "Super 23A"[4] should not apply to foreign mutual funds, securitizations, tender option bond programs, and other vehicles that (i) do not constitute what are generally known as hedge funds or a private equity funds and (ii) rely on affiliates for liquidity lines and other support.

Insurance

The Agencies should ensure that the Proposed Rule properly accommodates the traditional business of insurance by clarifying that the exemptions from the prohibitions on proprietary trading in Subpart B apply to exemptions with respect to the covered fund investment prohibition in Subpart C. The Agencies should also clarify that unregistered separate accounts of insurance companies will not be subject to the general prohibition on the sponsorship of or investments in covered funds. Further, insurance companies, which are subject to comprehensive state and foreign law, regulation and surveillance, should not be subject to the reporting and recordkeeping requirements set forth in Subpart D.

Compliance Program

The proposed programmatic compliance regime does not present a viable framework for assessing whether prohibited proprietary trading activity is occurring. We urge the Agencies to avoid applying the Proposed Rule on a transaction-by-transaction basis, which we believe is contrary to Congressional intent and the underlying objectives of promoting effective risk management and, by extension, the stability of the U.S. financial system.

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[4] Section 13(f)(1) of the BHC Act (and the Proposed Rule) prohibits a banking entity and its affiliates that serve, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, from entering into certain "covered transactions" as defined in Section 23A of the Federal Reserve Act of 1913. This prohibition is generally referred to as "Super 23A".

A reasonable approach would follow the principles and concepts set forth by the Financial Stability Oversight Council.[5] Banking entities should be able to examine their businesses at an activity level; design mandates and risk-management frameworks appropriate to conduct permissible activity; and then design compliance systems to monitor for risks that are inconsistent with the articulated limitations on risk-taking. Regardless of whether this or an alternative formulation is taken, however, compliance program requirements should not be imposed on foreign banking activities when the risk of such activities resides outside of the U.S.

Compliance Program Implementation Timeline

The Notice provides that the recordkeeping and compliance program requirements must be implemented by the effective date of July 21, 2012. Given that the comment period for the CFTC's related proposal will end sixty days after publication in the Federal Register (following which the Agencies must review and consider all comments received), it is likely that the final rule will not be issued until very near the July effective date. The Agencies should clarify that a full two-year conformance period will commence after the release of a final rule (after which time banking entities will be required to have (i) ceased activities prohibited by final rule and (ii) implemented necessary compliance systems.

[5] Financial Stability Oversight Council. *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Fund*, 69 (January 2011) [hereinafter FSOC Study].

Conclusion

We urge the Agencies to implement the Legislation in a manner that achieves its underlying objectives while preserving essential and customary market practices necessary to preserve the ability of the U.S. financial markets to allocate resources and manage risk in a manner consistent with safety and soundness. In particular, the Agencies must avoid provisions that unnecessarily interfere with regulated activity in foreign markets that do not further the objectives underlying the Legislation. The vast prohibitions, narrow exceptions, and extensive compliance burdens of the Proposed Rule will, in our view, limit banking entities' ability to facilitate lending, to hold inventory at levels sufficient to meet investor demand, and to participate actively in the market to price assets efficiently. In so doing, it will reduce liquidity and increase costs across a wide range of asset classes. The ripple effect would discourage investment, and limit credit for U.S. companies—stifling economic growth and job creation. As discussed in greater detail within our submission, we believe that a more balanced, less intrusive, principles-based approach would better satisfy the objectives underlying the Legislation without disrupting the traditional banking and statutorily authorized financial activities of banking entities. Particularly given the stakes involved, it is essential that the Agencies properly implement the Legislation regardless of the amount of time, coordination and analysis required.

Thank you for your consideration of our views. We would be pleased to discuss any of our comments at your convenience. If you have any questions, please contact me or my colleagues LaBrena Martin at 212-858-7110 or Richard Chase at 212-858-7111.

Respectfully,

ROYAL BANK OF CANADA

By: 

Mark A. Standish
Co-Group Head, Capital Markets

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The manner in which the Agencies propose to implement Section 13 does not further the objectives underlying the Legislation. Section 13(b) outlines the goals of the Legislation, which, succinctly stated, are to protect the U.S. financial system and taxpayers from excessively risky activities involving U.S. federally insured depository institutions and their affiliates. In furtherance of these objectives, the Legislation identifies two broad categories of activities that may pose unacceptable levels of risk to banking organizations: proprietary trading, and investments in, and sponsorship of, covered funds.[6] While Section 13 generally prohibits these categories it also explicitly permits certain other related types of activities by exempting them from the Legislation's prohibitions.[7] The permitted proprietary trading activities (also referred to as "exemptions") include: trading that occurs solely outside of the United States; market making and market making-related activities; underwriting; trading on behalf of customers; liquidity management; and risk-mitigating hedging activities. With respect to covered fund activities, the Legislation provides, among others, an exemption to the ban on investing in or sponsoring covered funds for activities that occur solely outside of the United States. Clearly, Congress deemed these permitted activities to be integral to the efficient and effective functioning of banking entities and financial markets in the United States.[8] Senator Dodd articulated Congress' intention to carefully balance activities that would be prohibited and those that would be permitted when he stated that "the purpose of the Volcker rule is to eliminate excessive risk-taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest."[9]

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6 BHC Act §13(a)(1).

7 BHC Act §13(d).

8 *See, e.g.*, portions of Senator Merkley's statement at 156 Cong. Rec. S5895-5896 (daily ed. July 15, 2010):

"[T]he underwriting and market making exemptions permit underwriting and market making-related transactions that are technically trading for the account of the firm but, in fact, facilitate the provision of near-term client-oriented financial services."

"[The 13(d)(1)(D) exemption for trading] 'on behalf of customers' . . . is intended to allow financial firms to use firm funds to purchase assets on behalf of their clients, rather than on behalf of themselves. . . ."

"The intent of [the 'near-term' requirement in the market making exemption] is to focus firms on genuinely making markets for clients, and not taking speculative positions with the firm's capital."]

9 156 Cong. Rec. S5906 (daily ed. July 15, 2010).

We strongly support the objectives underlying Section 13, and we commend the rigorous efforts of the Agencies to formulate, and seek comment on, a proposal to implement the Legislation.[10] We believe, however, that the Proposed Rule does not comport with the balanced approach dictated by the Volcker Legislation in that it effectively prohibits many of the activities Congress intended to preserve. Generally speaking, the Proposed Rule defines the range of prohibited activities under the Legislation very broadly, while at the same time interpreting the exemptions for permitted activities very narrowly. The circumscribed manner in which the Agencies define the exemptions would effectively prohibit many of the permitted activities that Congress specifically sought to exempt. It also renders the Proposed Rule overly complex. As a result, the Proposed Rule would create a regulatory paradigm that not only fails to satisfy the Legislation's objectives, but, most importantly, one that would ultimately harm the integrity of U.S. markets. A more balanced and less intrusive principles-based approach would more faithfully achieve the objectives of the Legislation. A final rule that expands the range and scope of permitted activities would satisfy Congressional intent and ensure that critical banking activities continue without unnecessary impediments.

II. THE PROPOSED RULE INAPPROPRIATELY LIMITS THE EXEMPTION FOR PROPRIETARY TRADING ACTIVITIES "SOLELY OUTSIDE THE UNITED STATES" IN A MANNER THAT FAILS TO SATISFY CLEAR CONGRESSIONAL INTENT, DAMAGES THE INTEGRITY OF U.S. MARKETS WITHOUT ANY CORRESPONDING ENHANCEMENT OF SAFETY AND SOUNDNESS, AND CONFLICTS WITH PRIOR REGULATORY PRACTICES AND LONG-STANDING PRINCIPLES OF INTERNATIONAL COMITY.

Congress made clear that foreign banking organizations' trading and funds activities conducted outside of the U.S. should not be subject to the prohibitions of the Volcker Legislation, recognizing that these activities are not supported by the federal safety net and do not present the risks to U.S. taxpayers that the Legislation was designed to prevent. This is especially true in the case of entities such as RBC that are subject to strong international capital standards and rigorous comprehensive consolidated home country supervision. The relevant statutory text focuses plainly on the location of banking entities' principal risk-taking activities — trading, investing or sponsoring — and confirms that such activities occurring "solely outside the United States" remain outside the scope of the Legislation.[11] The Proposed Rule, however, exceeds Congress' intent in that it extends the prohibitions of the Legislation to activity outside of the United States (even on foreign markets). Indeed, it is so narrowly drafted that virtually any nexus with

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[10] Indeed, we understand that one objective of the Agencies in formulating the Proposed Rule as comprehensively as drafted, including the numerous requests for comments, was not necessarily to include all the proposed requirements and limitations in the final rule, but was to be as exhaustive as possible in considering all issues.

[11] BHC Act §13(d)(1)(H).

the United States, or with a U.S. person (even while outside of the United States), would preclude a transaction from relying on the exemption.

Congress, however, did not intend for the Volcker Legislation to supplant foreign legal and regulatory preeminence over activities conducted by non-U.S. financial institutions and their non-U.S. affiliates outside of the United States. Senator Merkley confirmed this view in his statement that "the [offshore exemptions] recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law."[12]

To qualify for the exemption under the Proposed Rule, the Agencies require that: (i) no party to the purchase or sale can be a resident of the U.S.;[13] (ii) no personnel of the banking entity directly involved in the transaction can be physically located in the United States; and (iii) the purchase or sale must be executed wholly outside the United States.[14] None of these elements is contemplated by the language of the Legislation, which states only that the trading occur solely outside the United States. This formulation: (i) is inconsistent with the long-standing approach, developed by U.S. regulators over the last several decades, to the regulation of U.S. and non-U.S. activities of foreign banking entities; (ii) is unnecessary to achieve, and indeed is inconsistent with, the underlying objectives, legislative history and statutory text of the Volcker Legislation; (iii) will expand the reach of the Proposed Rule's requirements into otherwise regulated foreign markets; (iv) will effectively preclude foreign banks from accessing U.S. markets to engage in non-U.S. activities that are overseen by their own prudential regulators; and (v) will act as a disincentive to foreign banking organizations to conduct business in the United States — an outcome seriously detrimental to the safety and soundness of banking entities and the financial stability of the United States. At a practical level, the Proposed Rule would:

- restrict a foreign banking organization's trading desk in London, Toronto or Tokyo from using any U.S. trading platform, including the New York Stock Exchange or the various commodities exchanges in Chicago, to buy or sell securities or other financial instruments for its own account;

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[12] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (colloquy between Sen. Merkley and Sen. Levin).

[13] Proposed Rule §__.2(t) defines "resident of the United States" to include, among other things, any: (i) natural person resident in the U.S.; (ii) partnership, corporation or other business entity organized or incorporated under the laws of the U.S. or any state; (iii) agency or branch of a foreign entity located in the U.S.; and (iv) person organized or incorporated under the laws of any foreign jurisdiction formed by or for a resident of the U.S. principally for the purpose of engaging in one or more transactions described in §__.6(d)(1) (the exemption for trading activities solely outside the U.S.) or §__.13(c)(1) (the exemption for fund activities occurring outside the U.S.).

[14] Proposed Rule §__.6(d)(3).

- prevent employees of a foreign banking organization located in Houston from marketing a non-U.S. fund to clients in South America;

- prohibit a Canadian bank from selling interests in Canadian mutual funds to the 1.2 million Canadian "snowbirds" who regularly visit the U.S.;

- restrict foreign banking organizations from transacting in liquid securities of home market issuers in their home market in transactions involving U.S. persons; and

- frustrate foreign banking organizations' ability, at the parent bank level, to actively and dynamically manage their U.S. dollar balance sheets in a safe and sound manner.

These activities pose little, if any, threat to U.S. taxpayers and/or the U.S. financial system. Indeed, they provide support to the U.S. economy, contribute to the health of U.S. markets and help create U.S. jobs. As such, they should not fall within the Proposed Rule's prohibitions.

The extraterritorial impact of the Proposed Rule would have other consequences. Namely, its provisions would impinge upon sovereign and financial regulatory regimes in many jurisdictions outside of the U.S. that incorporate the global diversified banking model. This approach hardly reflects global coordination or consistency with historical principles of international regulatory comity.[15] At a time of extraordinary stress on the global financial system, foreign banking regulators should not be subjected to unnecessary stresses on their financial sectors created by extraterritorial applications of U.S. regulations. Additionally, imposing U.S. regulations on transactions and parties in foreign jurisdictions may result in consequences unforeseen by U.S. regulators including the creation of reciprocal stresses on U.S. markets. Such extraordinary regulation also invites similar responses by foreign regulators that would adversely impact the U.S. markets. No other country has unilaterally imposed such expansive prohibitions of trading and investment activity. Foreign banking regulators have instead been coordinating with their global counterparts to harmonize and standardize their regulatory regimes to minimize the opportunity for regulatory arbitrage and inconsistency. For example, when the G-20 leaders met in September 2009 to discuss OTC derivatives market reforms, the leaders made commitments concerning the standardization, central clearing and reporting of transactions. These coordinated commitments focused on mitigating risk through transparency, supervision and oversight rather than blanket bans against global financial activities.[16] Basel III (discussed in greater detail below) likewise

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[15] Ontario Financing Authority Volcker Rule Comment Letter, Jan. 31, 2012; the FSA/BOJ letter; UK Chancellor of the Exchequer George Osborne Comment Letter, Jan. 23, 2012; Letter from Michel Barnier, European Commissioner for Internal Market and Services, to the Agencies, Feb. 8, 2012.

[16] Financial Stability Board, *Implementing OTC Derivatives Market Reforms* (Oct. 25, 2010).

represents the type of coordinated effort by global regulators to establish international capital and liquidity standards for banking entities while minimizing conflicts and promoting the efficient operation of integrated financial markets.

The Proposed Rule's ripple effect would, among other things, discourage foreign banking organizations from continuing to operate in the U.S. (and, for that matter, from maintaining any other nexus with U.S. parties or markets). In addition to its substantial restrictions on the activities of foreign banking organizations the Proposed Rule would also require significant expenditures to comply with its extensive compliance program and reporting requirements. Some non-U.S. banking organizations may well make the determination to close their U.S. banking operations and withdraw from U.S. markets to avoid these restrictions/requirements. Such a result would limit credit for U.S. companies which, in turn, would stifle economic growth and job creation – an outcome squarely at odds with the objectives of the Legislation to preserve the stability of the U.S. financial system and protect U.S. taxpayers.

The Proposed Rule erroneously focuses on maintaining competitive equality between U.S. and foreign banking organizations in crafting the exemption. The Agencies should be guided by the stated objectives of the Volcker Legislation and clear Congressional intent.

The Agencies maintain that the inclusion of the additional requirements to the exemption in the Proposed Rule is needed to preserve "competitive equality among U.S. and foreign firms within the United States"[17] This articulated purpose, however, is nowhere to be found in Section 13 or its legislative history, with respect to the exemption for permitted trading activities solely outside the United States, and is not an appropriate basis for narrowing the exemption, for several reasons.

First, the plain meaning of the Legislation and Congressional intent: (i) unambiguously focuses Section 13's scope on the location of the proprietary trading itself and not on the location of counterparties, exchanges or agents and (ii) specifically limits the reach of the Legislation to avoid extraterritorial application to non-U.S. proprietary trading. When Congress wanted to prohibit the involvement of U.S. persons, it acted deliberately. For example, Congress expressly provided that the absence of participation of U.S. investors was an explicit requirement to the availability of the exemption for permitted covered fund activity solely outside of the United States.[18] The absence of a similar requirement with respect to the exemption for permitted trading activity solely outside of the U.S indicates Congress did not intend to prescribe one.

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[17] *See* 76 Fed. Reg. at 68, 880.

[18] *See* BHC Act §13(d)(1)(I); *see also* 156 Cong. Rec. S5897 (daily ed. July 15,2010) at S5897 (explaining the U.S. marketing restriction was designed "to maintain a level playing field by prohibiting a foreign bank from improperly offering its hedge fund and private equity fund services to U.S. persons when such an offering could not be made in the United States").

Furthermore, there is no record or other demonstrable factual basis to suggest that foreign banking entities would, in fact, have a material competitive advantage if the Agencies departed from clear Congressional intent. To the contrary, under the Legislation, any trading conducted by an international bank as principal in the United States (i.e., where the risk-generating activity is located in a U.S. entity) will remain subject to the same constraints that apply to U.S.-headquartered banking organizations. We also note that foreign banks often operate at a competitive disadvantage in the U.S. For example, foreign banking organizations have no access to federal programs such as the Troubled Asset Relief Program ("TARP"), and, as discussed in greater detail below, have limited access to U.S. dollar funding. Moreover, it is unclear that the prohibition of proprietary trading under the Legislation would adversely impact U.S. domestic banks. As Congress intended, permitting international banks to transact in U.S. financial instruments from outside the United States through U.S. affiliates and/or other agent or broker relationships would not prevent U.S. banks from competing in the United States on equal terms with international banks.

As noted, foreign-owned U.S. banking operations do not enjoy the same access to federal programs as U.S. banking entities. While one of the arguable purposes of the Legislation was also to limit inappropriately speculative proprietary trading by financial institutions benefitting from access to the Federal Reserve's discount window, we believe that President Obama's emphasis during his recent State of the Union address upon the use of customer deposits is telling and appropriate.[19] In this regard, although benefitting from deposit insurance and having access to the discount window are both deemed to comprise the "federal safety net," they are categorically different. According to the Federal Reserve's website, "[t]he Discount Window functions as a safety valve in relieving pressures in reserve markets; extensions of credit can help alleviate liquidity strains in a depository institution and in the banking system as a whole. It also helps ensure the basic stability of the payment system by supplying liquidity during times of systemic stress." The Federal Reserve functions as the central bank of the reserve currency of the world, and commensurate with this responsibility the Federal Reserve provides access to U.S. dollar liquidity through its discount window, which is critical to the efficient operation of the global markets. During the height of the financial crisis, to combat the historical stigma associated with borrowing from the discount window, many domestic and foreign banks were collectively encouraged by the Federal Reserve to utilize the discount window to combat the lack of liquidity that threatened the collapse of the global financial system. In the aftermath of the crisis, certain commentators mischaracterized access to the discount window as an extension of the federal safety net, ignoring the fact that the Federal Reserve operates the discount window on a discretionary and fully collateralized basis. Criteria for determining the eligibility of borrowers, collateral and terms of any

[19] In his State of the Union address on January 24, 2012, President Obama, referring to the proprietary trading ban said, in part, "[s]o if you are a big bank or financial institution, you're no longer allowed to make risky bets with your customers' deposits." A transcript of President Obama's State of the Union address can be obtained at http://www.whitehouse.gov/photos-and-video/video/2012/01/25/2012-state-union-address-enhanced-version#transcript.

borrowing from the discount window are all established and administered by the Federal Reserve under its mandate. Borrower eligibility and strength of collateral are assessed prior to the Federal Reserve granting borrower access to the discount window and prior to each credit extension. Given the parameters designed by the Federal Reserve governing the fully collateralized lending operation from the discount window, default risk to the Federal Reserve is virtually zero.[20] As previously stated, foreign-owned U.S. banking operations were not eligible for and did not receive any capital infusions under TARP; U.S. taxpayers did not support the activities of these banks. Accordingly, as opposed to U.S. banks, no implied subsidy (either from support provided by the U.S. taxpayer or through the discount window, as explained above) facilitated the activities of the U.S. operations of foreign banks during the financial crisis.

There are a variety of organizations that engage in proprietary trading in the U.S. that have a range of restrictions or limitations on their activities. At one end of the spectrum, hedge funds, private equity funds and insurance companies that form parts of the so-called "shadow" banking system are largely unaffected by the Legislation. Next, U.S. and foreign broker-dealers that are not bank-affiliated (including four primary dealers — Cantor Fitzgerald & Co., Jefferies & Company, Inc. Nomura Securities International, Inc. and Daiwa Capital Markets America Inc.) are subject to securities regulatory capital requirements, but are not subject to the prohibitions of Section 13. Certain of these first two categories may be deemed to be "systemically important." If so, they will be subject to oversight by the Federal Reserve Board and subject to enhanced prudential and capital requirements, but apparently not to the ban on proprietary trading. Finally, there are banking entities that are viewed as having access to the subsidy represented by the deposit insurance system. Along this spectrum there understandably are policy reasons for drawing distinctions in regulatory treatment, all tied directly to perceived risks they impose on the safety and soundness of the banking system and financial stability of the U.S. markets, and not competitive equality. An effort to narrow the trading exemption for foreign banking organizations, to achieve competitive parity as nearly as possible with U.S. banking organizations, as an end in itself, unrelated to the underlying objectives of the Volcker Legislation, is both misplaced and counterproductive.

As noted above, the Proposed Rule would subject a broad range of transactions, including some occurring completely on foreign markets, to its prohibitions and compliance and reporting requirements. It would also create a significant deterrent for foreign banking organizations to conduct business with any U.S. parties outside the United States. This, in turn, could spawn incentives to foreign market centers to limit participation by U.S. persons on their markets. Such a result will negatively affect the ability of U.S. investors

[20] Both the Bank of England and the European Central Bank permit access to their lending facilities by the jurisdictional operations of non-regional banks (U.S. headquartered banks). All banks with such access are subject to uniform eligibility requirements. Further, in the course of financial regulation in place prior to the crisis or new regulations being contemplated, such access to the secured lending facilities of either central bank is not a triggering event to the application of prescriptive or prudential banking regulation.

to access sources of liquidity outside the U.S. and, concomitantly, impair the non-U.S. activities of foreign banking entities that conduct business in the U.S.

Moreover, the Proposed Rule would depart from existing banking and securities law precedents that extend back several decades. The legislative record suggests that Congress crafted Section 13 on the assumption that the territorial scope of the Legislation would be addressed in a manner consistent with past practice. Placing the Volcker Rule in the BHC Act and incorporating reference to 4(c)(9) and (13) of the BHC Act, supports this view.

Existing precedents have looked to the location of the risk and management of the activity (and not to such factors as the location of the counterparty) in determining the "location" of cross-border trading.[21] For example, prior to the passage of the Gramm-Leach-Bliley Act, the Federal Reserve and the OCC repeatedly affirmed that a non-U.S. entity could conduct non-U.S. dealing activity through an affiliated U.S. broker acting as agent despite the Glass-Steagall Act's prohibition on banks and bank holding companies dealing and underwriting securities in the United States. In reaching this conclusion, the regulators attributed any such dealing and underwriting activities to the foreign affiliate that held the risk as principal and exercised ultimate control of the dealing/underwriting operation, and not to the U.S. agent.[22] Similarly, the SEC has long adhered to the position that when a foreign broker or dealer conducts securities transactions with U.S.

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[21] Indeed, in 1991 the Federal Reserve explicitly reversed the position it had originally taken in 1970 (American International Bank Letter re Investment in Henry Ansbacher & Co. Ltd., Nov. 13, 1970), and concluded that it was not inconsistent with a requirement that a foreign bank subsidiary of a U.S. banking organization only "engage in international or foreign banking and financial activity" for the foreign bank, acting from outside the United States, to make loans to U.S. borrowers for U.S. domestic purposes. 56 Fed. Reg. 19,549, 19,563-64 (Apr. 29, 1991).

[22] *See, e.g.*, OCC Interpretive Letter No. 371 (June 13, 1986) (granting Citibank, N.A. permission to acquire Vickers de Costa Securities, Inc., a U.S. registered broker-dealer, and concluding that Vickers could continue to conduct brokerage activities on behalf of foreign subsidiaries of Citicorp despite the Glass-Steagall Act's prohibition on dealing in securities in the United States because the principal risk of the trades would be borne outside of the United States and not by Vickers itself). *See also* Security Pacific Corp. ("SecPac") Federal Reserve Approval Letter (Apr. 18, 1988) (granting SecPac permission to acquire control of a U.S. registered broker-dealer and concluding that the broker-dealer could act as a broker for foreign affiliates of SecPac without violating the Glass-Steagall Act's prohibition on dealing in securities in the United States, focusing on the location of the risk and management).

The Federal Reserve, however, took a differing view in the context of cross-border underwriting by foreign banks that were not otherwise authorized to engage in underwriting in the United States. There, the Federal Reserve (in 12 C.F.R. § 211.605) concluded that public underwriting involving an affiliated U.S. agent of U.S. registered securities for distribution in the United States is an activity "in the United States" even if the underwriting risk is assumed outside the United States. The Federal Reserve reached this conclusion by reasoning that a U.S. affiliate without underwriting power could be evading the statutory framework under the Gramm-Leach-Bliley Act. However, recognizing the difference between U.S.-directed underwriting, on the one hand, and non-U.S. dealer transactions, on the other, the Federal Reserve did not extend this analysis to dealing in securities which foreign banks conduct in accordance with long-standing Federal Reserve precedent.

persons through a U.S. registered broker-dealer (which acts as agent or intermediary), that foreign broker-dealer's operations (including its dealing positions) remain, for regulatory, operational, capital and other purposes, outside of the United States and outside of the U.S. regulatory framework.[23]

Revisions to the text of the Volcker Legislation during the legislative process further indicate Congress' intent to permit activity occurring outside of the United States where the risk for the activity was also located outside of the U.S. Early drafts of the Legislation would have required an "investment or activity" to be conducted "solely outside of the United States" in order to qualify for the exemption.[24] Congress intentionally removed the "activity" prong of the requirement from the final statutory text, however, focusing instead solely on actions taken as principal that could create risk for a banking entity. The exemption for permitted trading outside the United States permits "proprietary trading . . . provided that the trading occurs solely outside of the United States."[25] Proprietary trading, in turn, is defined as "engaging as principal for the trading account" of a banking entity, clarifying that it is the action taken as principal that is regulated, and not other activities such as the actions of agents or counterparties.[26]

The purposeful removal of "activities" from the final statutory text reflects specific Congressional intent to focus on the location of the risk-generating activity rather than other activities unrelated to the location of actions taken as principal. Accordingly, it is clear that the word "solely" modifies proprietary trading as principal and not, as the Agencies have proposed, other related activities.

The legislative history of Section 13 thus supports the proposition that the scope of the exemption for permitted trading activity outside of the United States should be defined by reference to the location of the risk-taking principal activity and not on other factors (such as "competitive equality") not required by the terms or intent of the Legislation.

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[23] Rule 15a-6 under the Securities Exchange Act of 1934 Act, as amended (the "Exchange Act") exempts a foreign broker or dealer from the 1934 Act's registration requirements where such foreign broker or dealer effects transactions outside the United States in securities with U.S. investors through a U.S. registered broker-dealer, subject to certain conditions. *See also* SecPac SEC No-Action Letter (July 7, 1988) (one of several pre-Rule 15a-6 SEC no-action letters permitting a bank holding company's U.S.-registered broker-dealer subsidiary to act as agent in executing orders placed by non-U.S.-registered foreign affiliates).

[24] *See, e.g.*, Restoring American Financial Stability Act of 2010. S. 3217, 111th Congress § 619 (as reported by the S. Comm. on Banking, April 29, 2010).

[25] BHC Act §13(d)(1)(H).

[26] *Id.* at (h)(4). The exemption for permitted covered fund activities outside of the U.S. likewise refers to the "acquisition or retention . . . or the sponsorship of, a [covered fund] . . . solely outside of the United States." In this case, the Proposed Rule appropriately interprets the exemption to apply to activities conducted by a banking entity "as principal." (Proposed Rule § __.10(a)).

The Agencies must implement the Legislation with consideration of the international standards agreed to as part of the Basel III process, and without exporting U.S. regulatory requirements.

Basel III represents a global standard on bank capital adequacy, liquidity management and stress testing agreed upon by the banking regulators of the leading economies around the world, including banking regulators in the United States. This, the third of the Basel Accords, was developed in response to the deficiencies in financial regulation revealed by the financial crisis of the past five years. The components of regulatory reform embedded in Basel III include: (i) as to capital, the requirement that banks maintain higher levels of capital and better quality capital; (ii) as to liquidity, that liquidity regulation be moved from a "Pillar 2" supervisory matter to a "Pillar 1" set of required liquidity formulae; and (iii) that the capital and liquidity regulation of systemically important financial institutions (defined differently in different contexts) be more stringent than those applicable to other banks. The purpose of these changes was to make banks safer and sounder, better regulated and prepared to articulate and manage actual and contingent liquidity obligations.

Basel III, including its Liquidity Coverage Ratio ("LCR"), is designed prudentially to restrict inappropriate risk taking through an organized framework of asset-based liquidity requirements that effectively serve as disincentives to banks holding illiquid financial instruments. While work is continuing to finalize the LCR provision, the principled approach to developing clearly understood and agreed standards and measures is one that U.S. regulators should factor into their rulemaking.

Another reason to factor Basel III into the Volcker Legislation rulemaking process is the potential combined impact of these two reform initiatives. We understand that the Agencies may view the Volcker Legislation as complementary to the purposes of Basel III. We agree. We submit, however, that the Proposed Rule, in implementing the Legislation, would work at cross purposes with Basel III in that it would: (i) result in inadvisable concentration of risk by confining banking entities' liquidity alternatives to a one product (Treasuries) strategy; and (ii) force banking entities into long-term lending facilities funded by short-term borrowings. The potential for such result is particularly acute for foreign banking organizations, such as RBC, that currently are subject to home country liquidity rules and/or face a home country mandate for early adoption of Basel III. We are concerned that the only remedy for banking entities to mitigate such forced circumstances would be to severely tighten lending standards. Such a result would clearly be contrary to public policy goals of spurring lending to support economic growth.

In seeking to establish the proper balance between prohibited and permitted activities that is the cornerstone of the approach underlying the Legislation, the Agencies should give due consideration to the support provided by the Basel III reforms to the objectives underlying the Volcker Legislation. It is noteworthy that Congress created an exception for non-U.S. transactions even though at the time it acted the Basel III process had not yet

resulted in final international agreement. The adoption of Basel III makes it imperative that the Agencies now consider the implementation of the Volcker Legislation in light of the Basel III process. Importantly, the changes to Basel III were drafted, and will be implemented by, governments around the world. This is contrary to the Volcker Legislation, which was authored, and will be implemented unilaterally, by the United States.

We believe that it would be unnecessary and inappropriate, and in fact a violation of principles of international comity, for the United States to act extraterritorially to prohibit transactions that occur in non-U.S. jurisdictions in compliance with local law. Under the Basel III process, the role of controlling excessive risk in connection with such transactions is the responsibility of the home country and its regulatory system. Just as the United States wants and is obliged to regulate financial (and other) activities within its borders, international comity requires that foreign governments and regulators be allowed to regulate activities within their nations. Indeed, we imagine the United States would take issue with any foreign law, not agreed to in treaty or otherwise by the United States, that impinged upon the rights of American entities on U.S. soil. Accordingly, the Agencies should not attempt to restrict non-U.S. activity where the principal risk of the transaction resides outside the United States. As we outline below, we believe that the exemption for activity solely outside the U.S. should take this approach.

We recommend that the final rule focus on the location of principal risk in determining permissible trading activity solely outside the United States.

As stated above, the Agencies should not implement the Legislation in a manner that would limit or disrupt foreign banking organizations' non-U.S. operations when the risk of such activities resides solely outside the United States. Such limitations do not further the objectives underlying the Legislation of protecting U.S. taxpayers and promoting stability of the U.S. financial markets.

Accordingly, we recommend that the final rule focus on the location of the risk of trading activities of foreign banking entities as principal. In determining whether permissible activity satisfies the statutory requirement that foreign banking entities conduct proprietary trading "solely outside of the United States," we propose that the Agencies promulgate two key requirements; (i) the non-U.S. banking entity holds, reports and maintains the proprietary trading positions as principal (including financial obligation and ownership); and (ii) the non-U.S. banking entity makes the investment decisions and, if it uses a U.S. agent to engage in the trading, the non-U.S. banking entity establishes specific directives and parameters to be followed by the U.S agent when conducting the activity. We believe that these conditions better conform to the intent of the Legislation — namely to prevent risk to the U.S. taxpayer and enhance the liquidity and the financial stability of U.S. markets while maintaining foreign regulators' dominion over activities within their own jurisdictions.

III. THE PROPOSED RULE'S EXPANSIVE INTERPRETATION OF PROHIBITED PROPRIETARY TRADING ACTIVITY WOULD PREVENT BANKING ENTITIES FROM ENGAGING IN TRADITIONAL ASSET-LIABILITY AND LIQUIDITY MANAGEMENT ACTIVITIES.

The Proposed Rule's expansive interpretation of prohibited proprietary trading would effectively limit banking entities from engaging in traditional asset-liability and liquidity management activities. The Agencies have recognized that "[m]aintaining liquidity management positions is a critical aspect of the safe and sound operation of certain banking entities, and does not involve the requisite short-term trading intent that forms the basis of the statutory definition of 'trading account.'"[27] We agree, but we urge the Agencies also to recognize the equally critical necessity of asset-liability management ("ALM"). Among other things, this broader ALM capability is essential to manage the risks of, and need to maintain capital to support, lines of credit and other contingent credit obligations incurred in the ordinary course of serving the needs of banking clients. The Agencies must implement the Legislation in a manner that recognizes that safe and sound ALM does not constitute the sort of activity Congress intended to prohibit.

ALM capabilities cannot be implemented in a "one-size-fits-all" manner, but rather must recognize that business strategies, and the needs driving those strategies, may differ among banking entities. In this regard, foreign banking organizations operating in the U.S. actively manage their U.S. dollar denominated balance sheet to maintain sufficient liquidity. This is vital for foreign banking entities, as they generally lack the deep depositor base of U.S. banks and the related access to U.S. dollar liquidity. We fear that the Proposed Rule's expansive definition of "proprietary trading" would inappropriately restrict the ability of a banking entity to manage its capital and liquidity, an outcome that will have a negative impact on their safety and soundness.

The expansion of the definition of "trading account" to include the "status test" and the "market risk capital test" undermines the Legislation's "purpose test" and traditional ALM activities used to manage risk.

Subject to carefully defined exceptions, Section 13 prohibits a banking entity from engaging in proprietary trading, which is defined as "engaging as a principal for the trading account of the banking entity."[28] Section 13(h)(6) defines "trading account" by referencing whether the trade was "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)." The Proposed Rule, however, expands these key terms. The Agencies define proprietary trading as engaging as principal for the banking entity's trading account in any purchase or sale of a covered financial position.[29] A trading account is

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[27] 76 Fed. Reg. 68,862 (Nov. 7, 2011).

[28] BHC Act §13(h)(4).

[29] Proposed Rule § ___ 3(b)(1).

defined, in part, as any account used by a banking entity to acquire one or more covered positions principally for the purpose of: (i) short-term resale, (ii) benefitting from short-term price movements, or (iii) realizing short-term profits.[30] This short-term "purpose test," which is drawn directly from the stated objectives of the Legislation,[31] is unnecessarily expanded by the Proposed Rule's definition of "trading account" for the reasons set forth below.

Although the Legislation provides that the definition of trading account could include any other accounts as the Agencies may by rule determine,[32] the Notice states that "[i]n implementing the statutory definition of trading account, the proposed rule generally restates the statutory definition, with the addition of certain details intended to provide banking entities with greater clarity regarding the scope of positions that fall within the definition of trading account."[33] Instead of providing detail about the definition of trading account, however, the Proposed Rule adds two new tests that effectively supersede the "purpose test" in the Legislation. First, the Proposed Rule adds to the definition of "trading account" an account acquired to take a covered financial position if the banking entity is a registered dealer in the United States, or engaged in the business of a dealer outside of the United States, and the banking entity acts in a dealer capacity in a transaction (the "status test").[34] Under this test, any account used by a banking entity (either registered with the SEC or its foreign equivalent) to purchase or sell a covered position in its capacity as a dealer, regardless of whether the purpose of the transaction is short or long term, is a trading account and subject to the proprietary trading prohibitions. The Proposed Rule also adds to the definition of "trading account" any account used by a banking entity that is subject to the market risk capital rules or that takes covered financial positions that are subject to the market risk capital rules (the "market risk capital test").[35] Again, any trading account subject to the market risk capital rule would fall within the definition of "trading account," whether positions in the account were held for short-term trading purposes or not.[36]

As a consequence, the Proposed Rule significantly expands the definition of proprietary trading. The "status test" and "market risk capital test" exceed the objectives underlying

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[30] Proposed Rule § ___ 3(b)(2).

[31] BHC Act §13(g)(6).

[32] BHC Act §13(g)(6).

[33] 76 Fed. Reg. 68,857 (Nov. 7, 2011).

[34] Proposed Rule § __3(b)(2)(i)(C).

[35] Proposed Rule § __.3(b)(2)(i)(B).

[36] As a foreign banking organization, RBC is not subject to the market risk capital test. Hence, we have not analyzed this alternative definition in detail. Like the "status test," however, we question the need to include this type of test in addition to the more principles based "purpose test."

the Legislation, provide no enhancement to the safety and soundness of banking entities or the U.S. financial system and create an unnecessarily complex paradigm. Furthermore, the "status test" and "market risk capital test" would conflict with the "purpose test" where a dealer intends to enter into a long-term securities transaction. An example would be the purchase of a security in a dealer account having held-to-maturity or available-for-sale accounting treatment. Similarly, the "market risk capital test" would require a covered banking entity to classify any acquired covered financial position for which it calculates risk-based capital as a trading account position. This is so, even in instances where a position identified for market risk capital treatment does not meet the "purpose test." The fact that the market risk capital rule is not yet finalized presents additional challenges. By cross-referencing another proposed rule, the definition of "trading account" may capture activities that become part of the final market risk capital rule that were not intended or unnecessary to be so included.

The expansion of the definition of "trading account", particularly through the "market risk capital test," would potentially frustrate banking entities' ALM activities which are essential for effective risk management. For example, bonds that include embedded derivatives are often used for managing asset and liability mismatches. This activity would be prohibited as a result of the adoption of the "market risk capital test." As further discussed below, it is essential that the Agencies provide banking entities maximum flexibility to manage their risk effectively through ALM activities.

We believe that the "purpose test" in the Legislation, coupled with the absence of any distinction with respect to dealer-related activity or market risk capital in the definition of "trading account," and its use in the definition of "proprietary trading" in Section 13, indicates Congressional intent to limit the definition of trading account to the short-term "purpose test." For this, and the reasons discussed above, we maintain, that the additional "status" and "market risk capital" tests should be removed from the definition of trading account in the final rule. We acknowledge and support the additional arguments made in furtherance of this point in the comment letter submitted by SIFMA.

The proposed exemption from the definition of "trading account" for liquidity management accounts would frustrate customary ALM and liquidity management techniques essential to effective risk management, as well as the objectives of Basel III.

The proposed exception for "liquidity management" contained in the Proposed Rule's definition of "trading account" would frustrate customary asset liability and liquidity management practices, and interfere with initiatives being developed as part of Basel III. The ALM exception in the Proposed Rule also favors U.S. domestic banks which are primarily funded with large U.S. dollar retail and commercial deposits over foreign banks which are funded with proportionately more wholesale deposits. Retention and roll-off assumptions, rate-setting processes and structural interest rate risk management practices for U.S. dollar retail and commercial deposits significantly influence the approach a bank uses in managing its pool of liquid assets as part of its overall ALM program, including liquidity management, and choice of accounting treatment for liquid assets. Further, U.S.

and non-U.S. banks that have U.S. dollar balance sheet exposures comprised of authorized but undrawn loan commitments as part of their U.S. banking operations need the ability to dynamically manage this contingent exposure against a wholesale funding model that is markedly different from a retail and commercial deposit based one. For instance, the U.S. dollar treasury management operations of foreign banks must have the ability to manage liquidity, duration and interest rate risk associated with a wholesale funding maturity profile in satisfaction of existing requirements and proposed liquidity metrics under Basel III. This allows these departments to effectively manage funding and liquidity costs by earning the maximum amount on eligible liquid asset pools, which ultimately results in the ability to offer more abundant and competitively priced credit. Any liquidity management exception under the Proposed Rule must be sufficiently flexible not to impair or prejudice one funding model over the other. The failure to recognize and accommodate both retail and wholesale funding models could result in either a noticeable increase in the cost of credit or a meaningful contraction in credit availability, neither of which would be helpful for growth or job creation.

We recommend that the Agencies should instead exempt all *bona fide* ALM activities in order to further the Legislation's objective of promoting the safety and soundness of banking entities. Because liquidity management is only a subset of ALM activities, the Proposed Rule's exemption does not take into account a much broader set of activities that are essential to the management of risks associated with banking. Nevertheless, if the Agencies continue to limit the trading account exemption to liquidity management, we would make the recommendations set forth below.

While the Agencies have properly acknowledged the importance of liquidity management by establishing an explicit exemption for liquidity management activities, it is essential, that the conditions for an account or activity to qualify for this exemption not prevent use of well-established and customary liquidity management techniques necessary to comply with Basel III's liquidity initiatives. Among other conditions, the Proposed Rule requires that banking entities must have a "documented liquidity management plan" in place. We support such a requirement. In implementing such a condition, it is essential that such plans be permitted to react to changes not only in the nuances of banking entities' business strategies, but also in market conditions recognizing that banks manage these risks in a variety of ways.

We recommend the following additional changes to Proposed Rule Section __.3(b)(2)(iii)(C). First, paragraph (C)(2) provides that any transaction contemplated and authorized by the plan "be principally for the purpose of managing the liquidity of the covered banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes." We believe that the requirement that transactions be consistent with a liquidity management plan, coupled with the first half of this paragraph, which requires that transactions be principally for the purpose of managing liquidity, adequately restricts banking entities from using this exception to engage in impermissible proprietary trading. The further

limitations in the paragraph — that the transaction not have the purpose of short-term resale, benefiting from actual or expected short-term price movements, realizing short-term resale, etc. — prevent a banking entity from effectively managing for long term and contingent liquidity instruments. Further, if a banking entity is prohibited from seeking to maximize the price it receives upon disposing of these investments, there is a question whether the banking entity would be acting prudently. Thus, we strongly urge that the Agencies delete this language from paragraph (C)(2).

For similar reasons, the second requirement in paragraph (C)(3), that any position taken for liquidity management purposes be "limited to financial instruments the market, credit and other risks of which the covered banking entity does not expect to give rise to appreciable profits or losses as a result of short-term price movements" is much too restrictive, imposes serious workability issues, and should be removed.

We are very concerned about the requirements of paragraph (C)(4), because they seem to discourage long-term liquidity planning and impede the objectives of Basel III.[37] Specifically, for purposes of the exclusion, the requirement limits a plan's liquidity management to positions in amounts designed not to exceed "near term funding needs." This limitation could hamper a banking entity's ability to manage its liquidity across much longer prescribed time horizons. Our concern is that banking entities must manage liquidity needs for both short- *and* long-term purposes. In fact, discouraging long-term liquidity management would conflict with other regulatory regimes that require banking entities to manage medium- and long-term liquidity needs.[38] Paragraph (C)(4) also causes concern because of the ambiguity of the phrase "near term," which could impede both the LCR and the net stable funding ratio ("NSFR") requirements of Basel III. The general purpose of the LCR is to ensure that a bank can maintain a sufficient level of high-quality assets that can be converted into cash to cover liquidity needs for a 30-day time horizon under certain stress scenarios. The NSFR was created to promote the resilience of a bank over a one year period and encourage banks to fund their activities with stable sources of funding. Because "near term" is not defined (and given that a rebuttable presumption occurs regarding the existence of a "trading account" if certain assets are not held for at least 60 days,[39] a time period twice that in the LCR) it could conflict with the LCR requirements should "near term" be determined to be significantly less than 30 days. While the NSFR is still in the observation period and will not be implemented before 2018, the year funding horizon of this metric is in starker potential conflict with paragraph (C)(4). Although we do not endorse all aspects of the draft LCR

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[37] The requirements of paragraph (C)(4) may have similar negative effects on complementary guidance provided by national regulators. For example, in the case of Canada, as of August, 2011 OSFI required Canadian deposit taking institutions to maintain net positive cumulative cash flow in Canadian and other currencies combined for a period of twenty weeks.

[38] *Interagency Policy Statement on Funding and Liquidity Risk Management*, 75 Fed. Reg. 13,656 (Mar. 22, 2010).

[39] Proposed Rule § __.3(b)(2)(ii).

or the NSFR, which are not finalized and where there is a risk that both could be implemented quite differently by individual jurisdictions, we think it is critical that the liquidity management exception not constrain a bank's ability to comply with the final Basel III liquidity requirements.

Imposing unnecessary constraints on the liquidity management and broader ALM processes will undermine risk management efforts. Thus, we recommend that the Agencies preserve the flexibility of banking entities to effectively manage their liquidity needs by modifying or eliminating these conditions in the final rule as described above.

IV. THE EXEMPTIONS FOR PERMITTED MARKET MAKING, UNDERWRITING, TRADING ON BEHALF OF CUSTOMERS AND RISK-MITIGATING HEDGING ARE UNNECESSARILY NARROW AND EXCLUDE ACTIVITIES AND PRODUCTS THAT ARE ESSENTIAL TO THE PROPER FUNCTIONING OF THE FINANCIAL MARKETS AND EFFECTIVE RISK MANAGEMENT.

As proposed, the exemptions for permitted market making, market making related, underwriting and customer facilitation activities are too narrow. Without proper revision, the Agencies' proposed approach will interfere with (i) the proper functioning of the financial markets and (ii) effective risk management. For a discussion of these issues, please see Appendix A attached hereto.

V. THE EXEMPTION FOR PERMITTED TRADING IN GOVERNMENT OBLIGATIONS SHOULD BE EXPANDED TO INCLUDE (I) CANADIAN SOVEREIGN DEBT AND OTHER NON-U.S. SOVEREIGN DEBT, (II) U.S. STATE AND MUNICIPAL AND AGENCY OBLIGATIONS AND NON-U.S. EQUIVALENTS, AND (III) FUTURES AND DERIVATIVES THAT RELATE TO EXEMPTED GOVERNMENT SECURITIES.

The Agencies should adopt a general exemption with respect to the trading in Canadian sovereign debt as well as other non-U.S. sovereign debt. Failure to provide such an exemption would violate treaty obligations and principles of international comity and could undermine global economic stability. The Agencies should also exempt U.S. state and municipal and agency obligations and non-U.S. equivalents. Moreover, futures and derivatives instruments that relate to any of the exempted government securities should also be included in the exemption. For a discussion of these issues, please see Appendix B attached hereto.

VI. THE EXPANSIVE DEFINITIONS OF "COVERED FUND" AND "BANKING ENTITY" EXCEED CONGRESSIONAL INTENT AND CAPTURE CERTAIN ENTITIES THAT POSE LITTLE RISK TO THE U.S. FINANCIAL SYSTEM, INCLUDING CANADIAN MUTUAL FUNDS, SECURITIZATION CONDUIT VEHICLES AND PUBLIC WELFARE FUNDS.

We appreciate that in the Proposed Rule the Agencies have attempted to clarify the definitions of "banking entity" and "covered fund." However, we are concerned that, rather than refining those terms in a manner that will fulfill the purposes of the Legislation, the Proposed Rule expands the definitions in the Legislation to capture entities that do not pose risk to the U.S. financial system.

The final rule should limit the meaning of a covered fund to the commonly understood definition of hedge fund or private equity fund.

Notwithstanding the use of the terms "private equity fund" and "hedge funds" throughout the Legislation and Proposed Rule, a "covered fund" is broadly defined under each as any issuer that would be an investment company as defined under the Investment Company Act of 1940, as amended (the "1940 Act") but for Section 3(c)(1) or 3(c)(7) of that Act (the "ICA Fund Exemptions").[40] This definition is extremely broad, encompassing a much larger range of "funds," including activities central in traditional securitization activities, than is necessary to accomplish the goals of the Legislation. It reflects, however, the difficulty in defining what it means to be a hedge fund or a private equity fund rather than any demonstrated Congressional intent to capture every entity that might unexpectedly be caught within the meaning of those terms. We believe that the Agencies should, in accordance with Congressional direction set forth in the Dodd-Frank Act and its legislative record, refine the definition in the final rule to limit the reach of "covered fund" to include only what would traditionally be considered hedge or private equity funds. As discussed below, failure to do so would severely limit the ability of banking entities to provide credit and other customary banking and financial services to their customers. These clearly unintended results, in turn, would pose potentially harmful consequences to the U.S. financial markets and economy. In addition, the failure to do so would cause the so-called "Super 23A" provisions of the Legislation to apply far more broadly than could possibly have been intended by Congress, also creating clearly unintended and wholly counterproductive results.

Securitization Conduit Vehicles

Under the Proposed Rule, many traditional securitization vehicles, such as asset-backed commercial paper programs and tender option bond purchase programs ("TOB Programs"), would fall within the definition of a "covered fund" because most asset-backed commercial paper programs and all TOB Programs rely upon one of the ICA

[40] Proposed Rule § __.10(b)(1).

Fund Exemptions. These traditional types of securitization vehicles are long established and sound lines of business historically conducted by banking entities that have long provided a cost effective means of financing for many U.S. businesses and municipalities. Sponsoring or investing in them does not pose the risks to a banking entity that might arise from sponsoring or investing in traditional hedge funds or private equity funds. Sponsorship or investment in them by a banking entity should not be prohibited simply because such activities historically have relied on the same exemption from registration as an investment company.

Set forth in Appendix C is a specific discussion responsive to the request for comment (Notice Question 298) on the appropriateness of the manner in which the Agencies are proposing to implement Section 13(g)(2)[41] of the Volcker Legislation. As part of this discussion, we provide recommendations to the Agencies as to how best to fully effectuate Congressional intent in this area while also fully effectuating the Securitization Exclusion. In brief,

- We urge the Agencies to create an exception in the definition of "covered funds" for securitization issuers which have certain core characteristics. In Appendix CI, we propose a definition of "Securitized Asset Fund," together with related definitions, which incorporates these characteristics. The proposed exception would result in the securitization activities of such an entity (as described in the proposed definition) being exempt from the prohibited covered funds activities in Section 13(f)(1) of the BHC Act; OR

- If the Agencies prefer to work within the construct of the Proposed Rule, we request that (i) the modifications described in Section II of Appendix C be made to the provisions in the Proposed Rule that permit securitization activities and (ii) permitted securitization activities be exempted from new Section 13(f)(1) of the BHC Act, as implemented in proposed Section __.16(a)(1) of the Proposed Rule, which are more fully detailed in Appendix C, Section II.

Ashurst LLP, submitted a comment letter dated February 10, 2012, on behalf of various financial institutions, including us, addressing our belief that the (i) permitted activities exemption for trading in government obligations inappropriately and unnecessarily excludes securities issued by state and municipal agencies and (ii) activities of banking entities with respect to TOB Programs should not be subject to the restrictions of Section 13 of the BHC Act. As part of this discussion, we provide recommendations to the Agencies as to how best to fully effectuate Congressional intent in this area. In brief, we urge the Agencies to:

[41] This section sets forth the Rule of Construction that provides that the Volcker Legislation is not to be "construed to limit or restrict the ability of banking entities or nonbank financial companies . . . to sell or securitize loans...." (the "Securitization Exclusion").

- define the term "covered fund" to exclude TOB Programs, or, alternatively, to either:

  - exempt TOB Programs from the restriction on sponsoring covered funds or define the term "sponsor" in a manner that TOB Program sponsor activities are not included with the definition;

  - define the term "ownership interest" to specifically exclude any interest in a TOB Program; or

  - exempt TOB Programs from the restrictions on covered transactions with covered funds; and

- provide exemptions from the proprietary trading restrictions for (i) depositing assets into a TOB Program trust, and (ii) transactions in TOB Program securities.

Canadian mutual funds

Under the Proposed Rule, a Canadian mutual fund, which is regulated under Canada's securities laws, meets the definition of a "covered fund" insofar as it relies upon one or both of the ICA Fund Exemptions in order to ensure that only a limited number of U.S. residents hold its ownership interests based upon longstanding exemptive relief and guidance provided by the SEC.[42] Reliance upon this exemption is necessary, among other things, for offerings to Canadian citizens, and possibly other non-U.S. persons, traveling inside the United States. Despite the fact that Canada's securities laws are substantially comparable to those of the United States, only U.S. mutual funds are excluded from the definition of "covered funds" given that they are registered under the 1940 Act and therefore not offered based on reliance upon one or both of the ICA Fund Exemptions. Mayer Brown LLP submitted a comment letter dated January 19, 2012, on behalf of the major Canadian banks, which we joined, addressing the treatment of Canadian public funds and private funds under the Proposed Rule[43]. As part of this discussion, we provide recommendations to the Agencies as to how best to fully effectuate Congressional intent while also preserving the longstanding regulatory framework in this area by:

- excluding Canadian public funds from the proposed definition of "covered fund";

- excluding from the definition of "resident of the United States," as used in the foreign fund exemption, Canadian "snowbirds" and others who are temporary U.S. residents; and

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[42] The SEC provided relief to foreign mutual funds, beginning in the mid-1980s, which made limited private offerings to U.S. residents. *See* Touche Remnant & Co., SEC No-Action Letter (Aug. 27, 1984). A decade later, this relief was broadened to allow Canadian mutual funds, and later other foreign funds, to offer their fund shares to non-U.S. persons ("snowbirds") temporarily in the United States and in other circumstances. *See, e.g.*, Investment Funds Institute of Canada, SEC No-Action Letter (Mar. 4, 1996).

[43] A copy of this comment letter is available at http://www.sec.gov/comments/s7-41-11/s74111-75.pdf.

- exempting from the definition of "affiliate" all permissible funds, whether or not they meet the definition of "covered fund," to ensure that all permitted funds can trade for their own accounts, including making investments in other covered funds.

Mayer Brown LLP also submitted a supplemental comment letter dated February 13, 2012, which we joined, urging the Agencies to:

- Exclude Canadian Public Funds (as defined therein) (and other non-U.S. equivalents of registered investment companies) from the definition of "covered funds," and more specifically, to exclude them from the extraterritorial effects of the so-called "Super 23A" prohibition of Proposed Rule Section _.16.

- Exempt from the Super 23A prohibition any Canadian Private Fund (as defined therein) that is permissibly sponsored or controlled by a Canadian Bank under the exemption for fund-related activities of non-U.S. banks that are conducted solely outside of the United States. By definition, such funds have no U.S. investors and such transactions have no nexus with the United States.

- Exclude Canadian Funds (as defined therein) that are either not covered funds or are permissibly sponsored or controlled by a Canadian Bank under the foreign fund exemption from the definition of "affiliate" – and, thus, the definition of "banking entity."

The definition of "banking entity" is overbroad and will inappropriately apply the Legislation's strict prohibitions on proprietary trading and fund investing to an over-inclusive set of entities.

The term "banking entity" is a linchpin of the Volcker Legislation, because all entities that are covered by that term (and that are not otherwise excluded) will be brought under the proprietary trading and fund investing or sponsoring prohibitions. Because of the significant consequences that an entity would face if deemed a "banking entity," the Agencies should only adopt definitions from the BHC Act to the extent that such definitions would further the purposes of the Legislation. The Proposed Rule defines the term "banking entity" to include not only insured depository institutions (banks) and their bank holding companies, but also their subsidiaries and affiliates, incorporating definitions of those terms from Section 2 of the BHC Act. The FSOC Study recommended "that the relevant Agencies carefully consider the impact of certain BHC Act definitions on the Volcker Rule's definition of 'banking entity' and implement that term in a way that avoids results that Congress clearly did not intend in enacting the Volcker Legislation."[44] We further note that Senator Merkley explained that the reason affiliates and subsidiaries are included in the definition of "banking entity" is to prevent imperiling the bank holding company, which serves as a source of support for the insured

[44] FSOC Study, at page 69.

depository.[45] Nevertheless, the term "banking entity" extends to entities whose activities pose little or no risk to insured depository institutions. We believe that the Proposed Rule's adoption of the definitions of "affiliate" and "subsidiary" from the BHC Act creates the unintended results against which the FSOC Study warned. These terms would bring under the coverage of the term "banking entity" any company that controls, is controlled by, or is under common control with an otherwise covered banking entity and any company over which the covered banking entity is deemed to exercise a controlling influence. The Federal Reserve's interpretation of the BHC Act concept of "control," for reasons unrelated to the underlying purposes of the Legislation, adopts a much lower threshold than what is typically considered control. As a result, the definition could sweep in a variety of entities, including, for example, non-U.S. operating companies, including non-U.S. commercial companies deemed "controlled" by a covered banking entity, and the affiliates and subsidiaries of banks and bank holding companies. In this regard, Nixon Peabody LLP submitted a comment letter dated February 13, 2012, on our and PNC Bank's behalf more fully addressing these concerns as they relate to public welfare funds given that these latter structures frequently appear in low income housing tax credit and new markets tax credit transactions where participation is through investment or sponsorship by banks and bank holding companies and by subsidiaries or affiliates of each.

The Agencies should exclude certain other entities from the definition of "banking entity," including all "covered funds" in which the Volcker Legislation permits banking entities to invest in or sponsor.

To effectuate Congressional intent and create a precise and cohesive final rule, the Agencies should exclude the following entities from the definition of "banking entity:" (i) foreign mutual funds and (ii) covered funds in which a covered banking entity invests, or which a covered banking entity sponsors, in reliance on any of the Proposed Rule's exemptions.

The Notice states, that "[a]n entity such as a mutual fund would generally not be a subsidiary or affiliate of a banking entity under [the definition of 'banking entity'] if the banking entity only provides advisory or administrative services to, has certain limited investments in, or organizes, sponsors, and manages a mutual fund (which includes a registered investment company) in accordance with BHC Act rules."[46] Although we fully support the Agencies' exclusion of mutual funds and other U.S. registered investment companies from the definition of "banking entity," we urge that the Agencies clarify the application of the exclusion to foreign mutual funds in the text of the final

[45] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("The provision recognizes the modern reality that it is difficult to separate the fate of a bank and its bank holding company, and that for the bank holding company to be a source of strength to the bank, its activities, and those of its other subsidiaries and affiliates, cannot be at such great risk as to imperil the bank.").

[46] 76 Fed. Reg. 68,856 (Nov. 7, 2011).

rule. Not only would foreign mutual funds be captured by the definition of "covered fund" by virtue of their reliance on one or both of the ICA Fund Exemptions, as discussed in the Canadian context above, but they could also be deemed "banking entities" unless otherwise excluded, if, for example, they were considered an affiliate or subsidiary of another banking entity. To provide clarity and certainty, the Agencies should explicitly exempt registered and other publicly offered mutual funds, both foreign and domestic, from the definitions of "banking entity" and "covered fund" in the text of the final rule.

Although the Proposed Rule excludes covered funds relying on the asset management exemption in Section 13(d)(1)(G) of the BHC Act[47] from the definition of "banking entity,"[48] covered funds in which a covered banking entity invests, or which a covered banking entity sponsors, in reliance on any of the Proposed Rule's exemptions should also be excluded from the scope of the Volcker Legislation. The Agencies should exempt all permissible covered funds from the definition of "banking entity" in the final rule for the same reasons that the Agencies created the carve-out for funds that rely on the asset management exemption in the Proposed Rule and for the reasons set forth below.

In order to logically and consistently apply the Volcker Legislation's objectives, the definition of "banking entity" under the Proposed Rule should be amended to exclude all permissible covered funds. As the Notice explains, the purpose of excluding covered funds relying on the asset management exemption from the definition of "banking entity" is to "avoid application of Section 13 of the BHC Act in a way that appears unintended by the statute and would create internal inconsistencies in the statutory scheme."[49] As currently drafted, the Proposed Rule would define "banking entity" to include permissible covered funds, such as small business investment companies, funds in connection with risk-mitigating hedging activities and funds relying on the solely outside of the United States exemption.[50] As a result, these permissible covered funds would themselves be subject to the Volcker Legislation's prohibitions, including, for example, those related to acquiring or retaining an ownership interest in another covered fund, even though financial institutions that are banking entities, and presumably the true target of the Legislation, would be allowed to own or sponsor these permissible covered funds, subject to the Proposed Rule's limitations. The Notice does not cite any reason for excluding one category of permissible funds (*i.e.*, those exempt pursuant to the asset management exemption) from the definition of "banking entity" while leaving the others within the broadly defined term. We believe that this differentiation is an oversight and is precisely the type of unintended internal inconsistency that the Agencies have sought to avoid.

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[47] §§ __.11 and __.12 of the Proposed Rules implement this asset management exemption.

[48] § __.2(e)(4).

[49] 76 Fed. Reg. 68,855 (Nov. 7. 2011).

[50] *See* Proposed Rule § _.13.

Furthermore, prohibiting permissible covered funds from engaging in proprietary trading or investing in and sponsoring funds would not serve the Volcker Legislation's public policy purposes. The permissible covered funds were expressly excluded from the Volcker Legislation because investments in or sponsorship of such funds pose little risk to the financial stability of the United States. In fact, the trading, investment and sponsorship activities of certain permissible covered funds would promote public policy objectives, such as the growth of small businesses and risk mitigation.

Similarly, we are particularly concerned that the definition of "banking entity" would include permissible covered funds relying on the solely outside of the United States exemption.

Unless the Proposed Rule is revised, covered funds that foreign banking entities invest in or sponsor solely outside of the United States in reliance on the exemption in Section _.13(c) of the Proposed Rule, with no nexus to the United States, would be subject to all of the Volcker Legislation's prohibitions because the foreign funds would be caught under the "banking entity" definition. Given that these funds are required to be organized outside of the United States and that no ownership interest may be offered or sold to a U.S. resident in order to rely on the exemption, there is no reason that Congress would want to prohibit such funds from engaging in proprietary trading or from investing in and sponsoring other funds. Not only would this give rise to an unnecessary extraterritorial application of U.S. law, but it would also be impracticable for regulators to monitor these foreign funds, especially with respect to investors. Furthermore, such funds pose no risk to the FDIC insurance fund and no risk to the stability and safety of the U.S. financial system. Such funds need to be able to engage in proprietary trading and fund investing in order to operate. Additionally, there is an internal inconsistency brought about by not excluding funds formed pursuant to Section __.13(c) from the definition of "banking entity." Because funds formed pursuant to Section __.11 are not banking entities they can, among other things, invest in other covered funds, allowing a fund of funds structure, which is a common means of allowing investment diversification. This asymmetry was unlikely to be an intended result of the Proposed Rule's definition of "banking entity." For all of the reasons mentioned above, we ask the Agencies to narrow the categories of funds that are considered "banking entities."

VII. THE AGENCIES SHOULD ENSURE THAT THE PROPOSED RULE PROPERLY ACCOMMODATES THE TRADITIONAL BUSINESS OF INSURANCE BY PERMITTING PROPRIETARY TRADING AND "COVERED FUND" INVESTMENTS.

The Proposed Rule fails to appropriately accommodate the business of insurance. We concur with the Financial Services Roundtable's comment letter dated February 3, 2012 regarding this subject. For an additional discussion of these issues, please see Appendix D attached hereto.

VIII. THE AGENCIES SHOULD PROVIDE GREATER CLARITY REGARDING THE STATUTORY CONFORMANCE PERIOD AND ADOPT A MORE FLEXIBLE COMPLIANCE PROGRAM.

We urge the Agencies to adopt a flexible programmatic compliance program by eliminating certain compliance metrics and refining certain others. We also urge the Agencies to replace the transaction-by-transaction approach currently proposed with a risk-based approach at a broader operating level. Further, we ask that the Agencies clarify the expectations and requirements associated with the proposed conformance period. For a discussion of these issues, please see Appendix E attached hereto.

IX. BANKING ENTITIES CANNOT IMPLEMENT THE REPORTING, RECORDKEEPING AND COMPLIANCE PROGRAMS REQUIRED UNDER THE PROPOSED RULE BY JULY 21, 2012. THE EFFECTIVE DATE SHOULD BE EXTENDED, OR DEEMED THE STARTING DATE OF A CONFORMANCE PERIOD OF NO LESS THAN TWO YEARS, WITHIN WHICH BANKING ENTITIES MUST REACH FULL COMPLIANCE WITH THE FINAL RULE.

The Notice provides that, "the recordkeeping and compliance program requirements of the Proposed Rule, must be developed and implemented by the effective date of July 21, 2012."[51] This time will not adequately permit banking entities to develop and implement an appropriate compliance regime and recordkeeping and reporting functionality, particularly if the final rule is substantively modified from the Proposed Rule. The Agencies should clarify that a full two-year conformance period will commence after the release of a final rule (after which time banking entities will be required to have (i) ceased activities prohibited by final rule and (ii) implemented necessary compliance systems.

X. THE AGENCIES SHOULD MAKE FULL USE OF THEIR DISCRETION TO IMPLEMENT THE LEGISLATION IN A MANNER BEST CALCULATED TO ACHIEVE ITS UNDERLYING OBJECTIVES.

As noted above, Section 13(b)(2) directs the Agencies to adopt rules to carry out the provisions of the Legislation, and Section 13(d)(1)(J) (the "General Exemptive Authority") permits the Agencies to determine by rule additional activities that "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."[52] Senator Merkley stated clearly that the inclusion of the

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[51] 76 Fed. Reg. 68,855 (Nov. 7, 2011).

[52] BHC Act §13(d)(1)(J).

General Exemptive Authority exemption was "intended to ensure that some unforeseen, low-risk activity is not inadvertently swept in by the prohibition on proprietary trading."[53]

Our comments highlight areas in which we believe that the Proposed Rule departs from Congressional intent or otherwise may prevent activities that enhance the safety and soundness of banking entities generally and the financial stability of the U.S. more broadly. We urge the Agencies to reconsider the Proposed Rule and to promulgate a final rule that comports with the language and intent of the Legislation, which would allow the Agencies to more appropriately fulfill their statutorily mandated role and best achieve the goals of the Legislation.

[53] 156 Cong. Rec. S5897 (daily ed. July 15, 2010).

APPENDIX A

The exemptions for permitted market making, underwriting, trading on behalf of customers and risk-mitigating hedging are unnecessarily narrow and exclude activities and products that are essential to the proper functioning of the financial markets. These permitted activities must be expanded to include a broader range of critical financial instruments and market practices.

As discussed in greater detail below, we maintain that the exemptions for permitted market making, underwriting and trading on behalf of customers are unnecessarily narrow. The Federal Reserve has historically applied the terms "market making" and "underwriting" broadly and has permitted financial holding companies to engage in such activities as are permitted under the governing Federal or other jurisdiction's securities laws.[54] However, the Proposed Rule diverges from long-standing interpretations of these terms, which would prevent banking entities from engaging in activities that are essential to the proper functioning of the financial markets.

The Agencies should define the "near term" requirement in the underwriting and market making exemptions in such a way that recognizes the timeframe would differ depending on the liquidity of financial instruments and markets.

The exemptions for permitted underwriting and market making activities are limited under the Legislation to the reasonably expected "near term" demands of clients, customers and counterparties.[55] The Agencies should recognize in the final rule that the concept of "near term" is dependent upon and will differ with respect to different asset classes or financial instruments, as well as differences in the liquidity of markets. For example, while a retention period of 90-180 days for assets acquired in connection with underwriting activities has been recognized as acceptable by the Federal Reserve,[56] there are certain classes of less-liquid securities for which a longer expected holding period would be appropriate. Indeed, the Federal Reserve has permitted holding periods of up to one year in certain circumstances.[57] Recognizing that longer holding periods may be needed for less liquid assets promotes the safety and soundness of the financial markets and its participants because it allows banking entities to take positions in such assets, whether acting in an underwriting or a market making capacity, with the confidence that they would have the time necessary to prudently dispose of those assets and would not be forced into artificial "fire sale" liquidations. The final rule must also incorporate

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[54] Securities Act of 1933 §2(a)(11); Rule 144A; Regulation S.

[55] Proposed Rule §§ ___4(a)(2)(v),(b)(2)(iii).

[56] *See, e.g.,* Federal Reserve Interpretive Letter to George Varughese, Esq. (Apr. 19, 1988).

[57] *See, e.g.,* Federal Reserve Interpretive Letter to Richard E. Barber (Aug. 15, 1974): Federal Reserve Interpretive Letter to Barney Old Coyote (May 31, 1973).

flexibility based on market conditions, which can cause the level of liquidity, and hence the ease of disposing of market making inventory, to vary considerably.

The legislative history of the Volcker Legislation supports a broad definition of market making-related activities.

We maintain that the final rule should give full effect to Section 13(d)(1)(B), which permits banking entities to enter into transactions "in connection with market making-related activities, to the extent that any such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."[58] The Proposed Rule, however, contains additional conditions, which include, among other things, that: (i) the banking entity must hold itself out as willing to buy or sell for its own account on a regular or continuous basis, and (ii) the market making-related activity must be designed to generate revenue not derived from appreciation of positions held in trading accounts.

As discussed below, we are concerned, among other things, that the discussion of the first additional condition in the Preamble reflects a lack of recognition of the impact of variations in market conditions on different financial instruments. As further discussed, we believe the second additional condition is neither workable nor realistic. Taken together, we are deeply concerned that these additional conditions could prove dangerous to the health of the financial system because they would effectively prohibit certain customary market making practices – a substantial source of liquidity for U.S. markets. Traditional securities market makers, as well as traders at banks and securities firms engaged in market making-related activities, are critical providers of liquidity to financial markets through their willingness to take the other side of transactions in both liquid and illiquid markets. The additional conditions contained in the Proposed Rule could severely limit these traditional forms of market making activity, which would lead to decreased market efficiency, reduced price transparency, and greater volatility and instability in the financial markets.[59]

Congress did not intend for this exemption to be interpreted and implemented narrowly, as demonstrated by the statute's express direction that permitted activities not be limited solely to market making activities, but also more expansively to transactions "in

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[58] BHC Act §13(d)(1)(B).

[59] According to an Oliver Wyman study, "[e]xcessive or poorly implemented restrictions on market making may pose a serious threat to the strength of the U.S. capital markets, the safety and soundness of individual institutions, and the U.S. financial stability." Fundamental U.S. regulatory changes will reduce liquidity in local markets; for consumer transactions, restrictive definitions with regard to market making and trading on behalf of customers "may adversely impact liquidity and the ability of dealers to intermediate interest rate risk transfers from customers to the market"; and increased regulation in the U.S. may lead to the migration of market making to less regulated financial institutions or simply shift activities offshore. Oliver Wyman, *The Volcker Rule: Considerations for Implementation of Proprietary Trading Regulations* 11-14 (2011) [hereinafter Wyman, *Considerations for Implementation*].

connection with market making-related" activities. Congress intentionally used the term "market making-related activities" rather than "market making" in order to capture "certain legitimate client-oriented services, such as 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 [that] are intended to nonetheless meet expected near-term client liquidity needs."[60] The legislative history of Section 13 confirms that market makers should be permitted to assume residual risks that arise from their market making activities on behalf of customers, clients and counterparties. Senator Bayh stated (and Senator Dodd confirmed) that the Volcker Legislation would allow banks to "maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function."[61] Senator Bayh explicitly stated the context for his clarification, in cautioning that "[w]ithout that flexibility, market makers would not be able to provide liquidity to markets."[62] Accordingly, the Agencies should explicitly acknowledge that, depending on market conditions or the characteristics of a particular security, it may be appropriate—indeed necessary—for a firm to maintain inventories over extended periods in the course of *bona fide* market making-related activities.

The exception for market making-related activity in the Legislation reflects a clear desire by Congress to strike a balance to assure that the prohibition on certain proprietary trading does not undermine properly functioning markets or impair market liquidity. In this regard, we recommend that the Agencies clearly identify in the final rule a number of specific activities that fall within the scope of permissible market making-related activities. For example, intrinsic to the ability to engage in effective market making is the ability to establish positions, long or short, to enable the market maker to meet reasonably anticipated future client, customer and counterparty demand (whether or not such anticipated demand is ultimately realized), to stimulate a two-way market, and to establish a market making presence.[63] We ask that the Agencies specifically confirm that these activities are part of the market making-related activity exemption.

Furthermore, we suggest that the Agencies explicitly acknowledge that market making activities may be conducted separately from a market maker's other businesses, in particular its handling of customer or client orders on an agency basis. It is commonplace in the equity and fixed income markets for firms to separate their handling of routine retail customer order flow from their market making activities. These practices facilitate efficient execution of customer orders, improve the quality of executions, and manage conflicts of interest between a firm's agency and principal (dealer) functions. We urge

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[60] 156 Cong. Rec. S5896 (daily ed. July 15, 2010).

[61] *Id.*

[62] *Id.*

[63] The Proposed Rule appears modeled after equities markets, which can better tolerate the passive market making role contemplated. But that model does not work for many fixed income markets; nor is it likely to work for many derivatives markets.

the Agencies to acknowledge that, for conflict of interest management and other reasons, it is unnecessary for a firm's market making and agency businesses to be conducted together.

We also urge the Agencies to recognize that "wholesale" market making may be permissibly pursued by a banking entity. In carrying out a wholesale business, a firm makes a public two-sided market, even though the firm does not necessarily buy securities from or sell securities to persons who are treated as "customers" under the federal securities laws. The Legislation specifically provides that permissible market making-related activates can involve "counterparties" as well as customers and clients. It is irrelevant to an investor whether market liquidity is provided by a broker-dealer with whom the investor maintains a customer account, or whether that broker-dealer looks to another dealer for market liquidity. Therefore, customers should not be deprived of the market liquidity provided by banking entities serving as wholesale market markers. Wholesale market making has historically served an important role in securities markets, and we ask that the Agencies include this as a permitted market making-related activity in the final rule.

The requirement that a market maker "hold itself out . . ." should be eliminated or, in the alternative, flexibly interpreted to allow for market making-related activity in new or bespoke products and a broad categories of financial instruments.

Due to the narrowness of the Proposed Rule's treatment of the exemption for trading "on behalf of customers", discussed below (i.e., banking entities must act as riskless principal), banking entities generally will only be able to transact as a dealer or principal in transactions in new and bespoke products (and therefore new markets) if these transactions fit within the market making-related permitted activity. The Proposed Rule, however, requires that a market maker "hold itself out as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular or continuous basis." [64] We are concerned that this requirement may be interpreted to prohibit a covered banking entity from acting as an immediate market maker or block positioner in one-off transactions. Although this problem could and should be reduced by broadening the scope of the exemption for permitted activity on behalf of customers, as discussed further below, we believe that the market making-related exemption should also be amended to (i) eliminate the "hold itself out" requirement, noting that this criterion is not required by the Volcker Legislation or (ii) expressly include transactions in instruments that are new, that occur infrequently, or where a covered banking entity may not have previously held itself out as being willing to buy and sell the covered financial position on a continuous basis.

The Notice also provides that, "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

[64] Proposed Rule § __4(b)(2)(ii).

exemption for another type of covered financial position."[65] 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. We recommend that the Agencies provide specific guidance in the final rule of the kinds of activity in related financial positions that will be deemed to constitute market making-related activity. Such guidance, at a minimum, should include option market makers who should not only be deemed to be engaged in market making in all put and call series related to a particular underlying security, but should be permitted to trade the underlying security itself regardless of whether the trade technically qualifies as a hedging transaction. Similarly, convertible bond traders should be permitted to effect transactions in the associated equity security. If a trading desk regularly trades in standardized interest rate swaps and is approached by a client who requests that it engage in a customized interest rate swap, this should qualify as market maker-related. More broadly, a market maker in one issuer's bonds should be considered to be a market maker in similar bonds of other issuers. Otherwise, market makers may not be considered to be "holding themselves out" in similar products. Accordingly, to avoid confusion, we recommend that the Agencies clarify that in this context a trading desk is required to hold itself out as willing to buy and sell a particular type of product, rather than a specific covered financial product.

The exemption for permitted market making-related activities appears to be based on liquid exchange-traded equity markets and will not permit traditional market making activities in less liquid markets.

The Agencies should ensure that the final rule contains the flexibility to encompass market making across different asset classes, taking into consideration the diverse nature and characteristics of different types of financial instruments. It appears that the Proposed Rule has been developed principally with reference to liquid, exchange-traded equity markets. However, in order for banking entities to effectively engage in market making activities, the Proposed Rule must also take into account fixed income markets and markets for other financial products that are less liquid and more reliant upon active dealer quotes and trades to provide liquidity and satisfy customer demand.

The Proposed Rule contemplates a market making function that is quite constrained, even for liquid agency-type markets. Market makers would be confined to a large passive role, and would be permitted to engage in limited, if any, anticipatory hedging, price discovery and positioning. Even if greater flexibility were permitted beyond such a passive market making role, the Agencies must recognize that the market characteristics underpinning the Proposed Rule's framework are not realistic for many equity securities, as well as many, if not most, debt securities and other covered financial products. For example, in the U.S. corporate bond market, market makers will frequently buy a bond from a customer with the knowledge that they may have to hold the bond for a significant period of time before they will be able to find a buyer willing to purchase the bonds at fair

[65] 76 Fed. Reg. 68,870 (Nov. 7, 2011).

market value. To manage that risk effectively, market makers need significant flexibility to trade as market conditions warrant. If market makers were unable to acquire bonds from customers or counterparties with confidence that they would not be subject to second-guessing if the bonds remained in inventory for some time, the market makers would be forced to revert to a business model in which they only acquired bonds after finding a buyer on the other side. If a contemporaneous offsetting interest at current market prices could not be located, the customer would either be unable to sell the bond it is seeking to sell, or would receive an inferior price. This business model that would result from the Proposed Rule's limitations would seriously impair liquidity in less-actively traded securities and lead to inferior pricing on bond sales and a downward revaluation of bond inventories.[66]

Moreover, the markets for commodities, derivatives, securitized products and emerging market securities are even less liquid and would suffer even more serious dislocations than the bond markets. Market makers play a critical role in being willing to provide bids and offers for illiquid products for which there may be a dearth of other immediate buyers or sellers. Without these market makers, decreased liquidity would result in increased price volatility for market participants. This exposes the public to greater risk exposure and would increase the cost of hedging.[67] It would also impair the price discovery these markets serve for underlying cash markets, posing the risk of inefficiencies and dislocations that could spill over to the larger economy. Therefore, the Agencies should not condition the availability of the market making exemption on a banking entity's correct prediction of the near term demand of clients, nor should the Agencies impose limitations that govern the disposal of positions, whether established in market maker transactions or in anticipation of client, customer or counterparty orders that do not materialize.

Market makers should be permitted to engage in the range of activities that are currently considered to be part of market making, and should not be limited to passive market making-related activity.

Although the Proposed Rule does not per se require market making-related activities to be "passive", the Notice states that a market maker's activities in an exchange-traded security are consistent with reasonably expected near-term customer demand "when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy."[68] We believe that this approach is unnecessarily restrictive and does not reflect the full range of trading inherent in market making in exchange-traded securities. In particular, we

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[66] Oliver Wyman, *The Volcker Rule Restrictions on Proprietary Trading, Implications for the US Corporate Bond Market* 6 (2011) [hereinafter Wyman, *US Bond Market*].

[67] Wyman, *Considerations for Implementation*, at 50.

[68] 76 Fed. Reg. 68,871 (FRB 59 Nov. 7, 2011).

believe that market makers need the ability to enter market or marketable limit orders at times to dispose of long or short positions taken in prior marketing making transactions or to build inventory in connection with acquiring a block trade for a customer or anticipating customer demand. As previously discussed, we believe Congress intended for the market making-related activity exemption to be interpreted broadly, and the language in the Notice appears to further restrict an exemption that we believe is already prohibitively restrictive.

The ability of issuers to raise capital will be negatively impacted by the narrow interpretation of market making-related activities under the Proposed Rule.[69]

U.S. corporations raise funds by issuing equity and debt securities through the U.S. capital markets. These corporations rely on investors, who wish to invest available capital in U.S. corporations, to purchase those securities. Investors will only do so, however, if they believe they subsequently will be able to dispose of their investment in the secondary market, usually to banking entities that make markets in the securities. If banking entities are significantly restricted in their secondary market making activities, it will be harder for investors to sell purchased securities at a reasonable price, and demand for initial issuances will suffer. In addition, active market making provides banking entities that serve as underwriters with the knowledge and experience needed to price offerings appropriately. An excessively narrow definition of market making-related activities would inhibit this price discovery function and could lead underwriters to be overly cautious (and less accurate) with respect to pricing new issues. These undesirable consequences could significantly impair capital formation, making it difficult for the U.S. corporations that rely on funds raised in the U.S. primary market to finance new projects and sustain U.S. employment. Moreover, such results could well cause the migration of capital-raising activities off-shore.

The requirement that market making-related activity be designed to generate revenue not derived from the appreciation of traded positions is inconsistent with customary market making practices.

The Proposed Rule includes a requirement that market making-related activity be designed to generate revenue that is not derived from the appreciation of positions held in trading accounts. Instead, revenues may only be generated from fees, commissions, bid/ask spreads or other similar sources. We believe this requirement raises several problems and concerns.

The requirement that market making revenues be only generated from commissions and fees is simply not realistic. Appreciation in the value of financial assets is inherent in market making activities because such activities cannot take place without price fluctuations, which include an increase in value of the underlying asset. Consequently, firms will inevitably and rationally seek to generate income from their financial positions.

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[69] Wyman. *Considerations for Implementation*, at 32.

The suggestion that firms need to separate income generated from the appreciation of positions from income generated from bid/ask spreads (or, in industry parlance, the "dealer's turn") may be theoretically feasible (although not realistic in practice) in the actively traded agency-dominated equity markets contemplated by the Proposed Rule. However, in more thinly traded equities, and most debt markets, this distinction will prove to be difficult, if not impossible, to make. Assume, for example, that a customer wants to immediately sell a large position in bonds for which no ready market exists. A trader knows that the bonds would have to be steeply discounted in order to move the entire position in a riskless principal trade. Likewise, the trader is aware that the trading desk, if it were to facilitate the customer order, would face a steep price drop unless it were willing to carry the position for days or even weeks. The customer, aware of the illiquidity but seeking an immediate sale, is willing to sell the bonds to the trader at a smaller, but still meaningful, discount. In this example, if the trader buys the full amount of the bonds at a discount, and is able to sell out the position over time at a handsome profit, it is unclear whether the trader has generated revenues from market appreciation or the bid/ask spread.

More generally, equity, debt, derivative and commodity traders, in their dealer capacity, make continuous decisions regarding the size and price of quotes they are willing to make based on maximizing their profit potential while accommodating the needs of customers, clients and counterparties. In so doing, they look to factors such as current inventory levels, supply and demand fluctuations, and opportunities to capitalize on temporary pricing dysfunctions. This is not only sound economic behavior, but it also recognizes the reality that other dealers, as well as hedge funds and other institutional investors, are making similar decisions based on their market perceptions. A trader who assumes a long position in one corporate bond in the course of accommodating a customer, may seek to manage the risk of that position by either selling those bonds or, possibly, taking a short position in a similar corporate bond. Today, the choice of the offset or hedge will frequently be based on the trader's perception of which alternative holds the greatest potential for profit or least risk of loss. If there were an opportunity to sell the specific bond issue, but in the trader's judgment it would be more profitable to instead take an offsetting position in a different bond, and that judgment turns out to be well-founded, it is unclear whether the trader gained revenues from price appreciation of the two offsetting positions or from the bid/ask spread in the respective bonds. These ambiguities would significantly impede the ability of traders to conduct safe and beneficial business activities for their customers.

We also believe the revenue limitation is unnecessary. All firms set trading limits, by desk, by trader and by security. These limits can and should be set to meet the statutory requirement that they be designed to permit the trader to reasonably satisfy the near-term demand of clients, customers and counterparties. Firms can and should be expected to monitor their traders for compliance with these limits. In turn, regulators would be able to examine the limits and audit the firm's compliance with them. With such a regime in place, a trader or a firm that systematically maintained inventories that were unrelated to their market making responsibilities should be apparent. This formulation would result in

compliance with the statutory requirement, without requiring firms to make artificial distinctions between profits from spreads and profits from market appreciation, and more importantly, without unnecessarily inhibiting an important source of market liquidity.

Arbitrage trading with non-customers serves important market making-related functions and should be included as part of the exemption.

The Notice provides 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-related exemption."[70] We disagree with this formulation of the market making exemption, as many markets, such as the futures and options market, rely on the arbitrage activities of market makers to maintain liquidity. Arbitrage trading is also necessary more generally to maintain price efficiency in markets. For example, index arbitrage keeps the price of an exchange-traded fund close to its net asset value. It is also essential to maintain convergence with underlying instruments for cash-settled options, futures and index-based products. Moreover, the "wholly as principal"[71] standard raises practical difficulties of dividing market maker activities into permitted hedging and customer intermediation activities and impermissible arbitrage activities in order to determine their proportionality. Therefore, we believe that the Agencies should not prohibit arbitrage trading but should instead monitor for otherwise impermissible positions and activities through compliance and examination tools.

Bona fide market makers in foreign jurisdictions should be eligible for the market making exemption regardless of that jurisdiction's regulatory requirements.

With respect to the purchase or sale of securities, swaps or security-based swaps, the Proposed Rule requires that a market maker (i) be registered with the SEC or CFTC as appropriate, or (ii) be "[e]ngaged in the business of a dealer outside of the United States and subject to substantive regulation of such business in the jurisdiction where the business is located."[72] This condition seeks to replicate the U.S. dealer registration requirement, but focuses on the substance of the regulation rather than whether the offshore market maker is recognized and registered as a dealer in its home jurisdiction. We note that the principal stock exchange in Canada has dispensed with specialist or market maker registration for the dealers that operate in Canada. We believe that the market making-related activities of foreign banking organizations should qualify for the exemption as long as they conduct *bona fide* market making-related activities that otherwise meet the exemption's requirements without reference to offshore substantive regulation. Without this, foreign banking organizations operating in countries with a

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[70] Preamble at 76 Fed. Reg. 68,871 (FRB 58-59 Nov. 7, 2011).

[71] *Id.*

[72] Proposed Rule §§ __4.(b)(iv)(A)(2), (B)(2) and (C)(2).

different regulatory structure may be unable to participate in and provide market liquidity. Likewise, we do not support a requirement that the foreign banking organization be registered as a dealer in its home country if such registration requirement exists in the market maker's jurisdiction, because the registration requirement in such jurisdiction could be narrower than the U.S. dealer requirement.

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

The Proposed Rule requires that covered financial positions purchased or sold as part of market making-related hedging be (i) "purchased or sold to reduce the specific risks to the covered banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings acquired pursuant to" the market making-related permitted activity *and* (ii) meet all of the requirements of the risk-mitigating hedging permitted activity.[73] We believe that this dual requirement is overly burdensome and unnecessary. We maintain that the requirements of clause (i) are sufficient to meet the risk mitigating objectives underlying the Legislation. Indeed, the Agencies fail to demonstrate the need or the benefit of imposing a higher burden to qualify a hedge tied to market making-related permitted activity than to qualify other forms of risk-mitigating hedging activity.

To foster the safety and soundness of banking entities, we believe that the Agencies should encourage, not discourage, appropriate market making-related hedging. Hedging is a necessary and desirable part of the market making process. The ability of market makers to freely offset or hedge positions is what, in most cases, makes them willing to buy and sell covered financial positions to and from customers, clients or counterparties. Any impediment to hedging market making-related positions will decrease the willingness of banking entities to make markets and, accordingly, reduce liquidity in the marketplace. In fact, Appendix B of the Proposed Rule indicates that appropriate risk management, including risk management facilitated through hedging, is an indicator of market making activity.[74] As a result, we believe that a transaction in a covered financial position should fall within the market making-related permitted activity as long as it mitigates the risk associated with positions acquired through permitted market making-related activities.

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[73] Proposed Rule § __.4(b)(3).

[74] Proposed Rule App. B Part III.C; *see also* App. B, Part III.A ("The primary purpose of market making-related activities . . . is not to earn profits as a result of movements in the price of positions and risks acquired or retained; rather a market maker generally manages and limits the extent to which it is exposed to movements in the price of principal positions and risks that it acquires or retains . . . [and] will eliminate some or all of the price risks to which it is exposed.").

Interdealer trading activity between brokers and dealers should be expressly included in the market making exemption.

We request that the Agencies explicitly incorporate normal interdealer trading activity between brokers and dealers as part of the market making exemption. The market making exemption in the Volcker Legislation applies to market making activities for clients, customers or counterparties.[75] The inclusion of "counterparties" demonstrates that Congress intended the market making exemption to apply more broadly than to just "clients" and "customers." Furthermore, we agree with the Agencies' statement that a market maker's "customers" generally vary depending on the asset class and market in which the market maker is providing intermediation services. Footnote 199 of the Notice states that, for securities executed on an organized exchange, a customer is a person "on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant" and that, in an over-the-counter market, a customer is "a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services."[76] We believe that, taken together, the Legislation and Proposed Rule clearly allow interdealer market making where brokers and dealers act as customers. We urge the Agencies, however, to explicitly incorporate providing liquidity to other brokers and dealers as part of the market making exemption because interdealer liquidity is crucial for many markets.

The scope of permitted "block positioning" must be expanded beyond equities to include other financial instruments.

The Proposed Rule permits block positioning "if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading."[77] The Agencies do not define "block positioner," but note that the SEC's existing definition of "qualified block positioner" in Rule 3b-8(c) "may serve as guidance in determining whether a block positioner engaged in block positioning is engaged in bona fide market making-related activities."[78] The definition of "block positioner" in Rule 3b-8(c) requires, among other things, that the block positioner determine that the block could not be sold to, or purchased from, others on equivalent or better terms, and that the block positioner sells the shares composing the block as rapidly as possible commensurate with the circumstances.

We maintain that Rule 3b-8(c) does not properly encompass all the "block positioning" market making activity meant to be covered by the Legislation. As an initial matter, we

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[75] BHC Act §13(d)(1)(B).

[76] 76 Fed. Reg. 68,890 note n.199 (FRB 99 n. 199 Nov. 7, 2011).

[77] 76 Fed. Reg. 68,871 (Nov. 7, 2011).

[78] 76 Fed. Reg. 68,871 n.151 (Nov. 7, 2011).

would note that Rule 3b-8 was adopted to restrict access to market maker credit from banks to a narrow class of equity market makers. This limitation is unrelated to the purpose of the permitted activity under the Legislation, which is intended to allow market makers to continue their critical roles in the financial markets. In addition, because Rule 3b-8 applies to equity blocks, it does not take into account market making activities in other markets. First, it should be noted that a much wider range of transactions entered into by institutions in less liquid instruments have the price impact characteristics of block trades in equity markets. Understandably the block positioner exemption is of heightened importance in these markets. Second, it is unclear how a block positioner in less liquid markets would determine that a block could not be sold to or purchased from others on equivalent or better terms. This appears to be a concept carried over from liquid, exchange-traded equity markets, in which block positioners can look at the prevailing market price and widely disseminated quotes from others. In less liquid markets, market makers face a heightened risk that their bids are off-market. In addition, a requirement to sell the instruments comprising the block "as rapidly as possible" needs to be applied with great care. To demand disposition of assets in an illiquid market as rapidly as in liquid equity markets could result in "fire sales" at seriously depressed prices. If such an approach is adopted, we anticipate that banking entities will be much less willing to facilitate client requests for block trades. Market liquidity will be seriously impaired as institutional customers and commercial end users will be unable to find banking entities that are able to facilitate their need to trade in size at a price reasonably related to the market.

The exemption for trading on behalf of customers should recognize the need for banking entities to provide traditional customer services.

The Agencies should expand the scope of the exemption for permitted trading on behalf of customers to include traditional customer-facing activities that would otherwise be prohibited under the Proposed Rule. Section 13 permits banking entities to engage in the "purchase, sale, acquisition, or disposition of securities and other instruments ... on behalf of customers"[79] The Proposed Rule, however, appears to require that the banking entity act as riskless principal in these transactions.[80] This restriction renders the exemption too narrow to accommodate certain important customer-facing activities.

We believe that the exemption should be available for transactions undertaken at the instruction or request of a client or customer or in anticipation of such customer instruction or request. This is critical to ensure that banking entities will be in a position to continue to provide necessary and customary services to their clients and customers, which can range from arranging riskless principal trades to purchasing or acquiring securities at a customer's request. For example, in fixed income transactions, relative value trading would be frustrated by the narrowness of the current exemption in the

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[79] BHC Act §13(d)(1)(D).

[80] Proposed Rule § ___. 6(b)(2)(ii).

Proposed Rule because although a client might want a particular fixed income product, the banking entity may know of a similar and equally suitable product based on the banking entity's relationship with that client. However, unless the banking entity can provide the customer with certainty that it will be able to provide the similar product and at a certain price, the customer will not be interested in the trade. In order for the banking entity to be able to accomplish this, it must be able to buy and hold the similar product and have it ready in inventory. It is important to remember that customers rely on banking entities to act as counterparties to their transactions—an important source of liquidity in the marketplace. Restricting the exemption to instances where the banking entity is acting strictly in a riskless principal capacity would severely curtail these activities.

The following examples demonstrate why the approach we recommend is more appropriate than the strict riskless principal approach in the Proposed Rule. Customers frequently request firms to execute "volume weighted average price" (or VWAP) trades, or other forms of algorithmic trades. In some cases, the customer will ask that the VWAP or similar trades be executed on a strict agency basis. More frequently, the customer will seek to lock in an execution at a specified price, or pursuant to a specified formula. The firm then bears the risk, and may stand to benefit, if the execution it obtains in the market is better than the agreed upon price. In all cases, the trading activity is initiated at the customer's request. As another example, a customer may contact a broker-dealer to buy some bonds in which the broker-dealer does not make a market. The broker-dealer may be unable to find a dealer making a competitive market in the bonds, but locates a source to borrow the bonds. If the broker-dealer effects a short sale to the customer and hedges its exposure with related bonds, it will have provided liquidity to the customer. But the broker-dealer's activity would constitute neither market making nor trading on behalf of a customer. Moreover, in the derivatives and structured products arena, customers may be interested in investments that are not readily available in the market. Banking entities respond to these customer demands by structuring or creating bespoke products that meet the customer pricing needs. Banking entities then seek to offset the risk associated with the bespoke products by entering into transactions in standardized financial products. We urge the Agencies to clarify that this type of trading activity would be considered permissible trading on behalf of customers because it is clearly not the sort of risk-taking proprietary trading intended to be prohibited by the Volcker Legislation.

In order to address the Agencies' risk mitigation concerns, we would propose that the Agencies require banking entities to demonstrate that they are managing the assumed risks in a safe and sound manner, using appropriate hedging techniques when possible. The Agencies could use the examination process to enforce compliance with this requirement. This balanced approach would allow banking entities to service their customers effectively, while still mitigating any risk involved with trading.

We believe that our recommended approach is consistent with the legislative intent behind the trading on behalf of customers exemption.[81] A focus on the customer's request as the test of permissibility is supported by OCC and Federal Reserve decisions that authorize national and state member banks to engage in otherwise impermissible securities activities so long as the transaction is customer-driven.[82] In crafting the final rule, we recommend that the Agencies rely on this precedent, substituting the requirement that the banking entity must act as riskless principal with the requirement that the transactions be initiated at the request of the customer.

The exemption for underwriting should be broadened so as not to exclude certain traditional underwriting activities.

As proposed, the exemption for underwriting activities is too narrow. Particularly in the recent economic environment, where maintaining rapid issuer access to capital is, more than ever before, an imperative, any regulatory actions that would significantly restrict the availability and or increase the cost of capital for issuers can only further erode the already fragile economy and reduce the likelihood of a sustained economic recovery. Among other things, the exemption for underwriting activity in the Proposed Rule requires that the activity be effected solely in connection with a "distribution" of securities for which a banking entity is acting as underwriter. To qualify as a distribution, the Proposed Rule requires that the offering of securities must: (i) be of a certain "magnitude"; and (ii) involve "special selling efforts". The Proposed Rule does not define "magnitude" or "special selling efforts" but notes that the Agencies may consider factors similar to those contemplated under Regulation M under the Exchange Act in determining whether an underwritten offering qualifies as a "distribution."

We understand the surface appeal of looking to Regulation M for guidance. However, Regulation M was adopted for different purposes, and the consequences of meeting the definition of distribution – i.e., the regulation of activity that constitutes a "distribution" and the prohibition of activity that is not a distribution – are markedly different There may be certain underwritten offerings that do not satisfy the "magnitude" criterion, even though executed in the manner of an ordinary course underwriting. For example, the sale by a banking entity of securities of a large cap issuer for a selling shareholder may be executed as an underwritten transaction in the normal course, even though the sale may not be of sufficient "magnitude" to qualify as a "distribution" under the Proposed Rule.

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[81] *See* 156 Cong. Rec. S5896 (daily ed. July 15, 2010), where Senator Merkley states the following: "Subparagraph (d)(1)(D) permits the acquisition of the securities and other affected financial instruments 'on behalf of customers.' This permitted activity is intended to allow financial firms to use firm funds to purchase assets on behalf of their clients, rather than on behalf of themselves. This subparagraph is intended, in particular, to provide reassurance that trading in 'street name' for customers or in trust for customers is permitted."

[82] *See, e.g.*, OCC Interpretive Letter No. 494 (Dec. 20, 1989), Federal Reserve Interpretation, Board Statement Concerning the Acquisition of Stock by State Member Banks to Hedge Equity Derivative Transactions" (Feb. 21. 2002).

Further, there may be certain offerings that may fall within the traditional scope of a banking entity's underwriting activity that arguably may not meet the special selling efforts criteria contemplated under Regulation M, including, "at-the-market" offerings conducted off issuer shelf registrations. We request that the Agencies confirm that the foregoing types of offerings would fall within the underwriting exemption.

Furthermore, there are certain underwritten offerings that may satisfy the "magnitude" and "special selling efforts" criteria contemplated under the Proposed Rule but that are specifically exempted from the provisions of Regulation M under the Exchange Act. For example, Rule 101(b)(10) of Regulation M exempts certain transactions from the general prohibitions of Rule 101.[83] We request that the Agencies confirm that offerings conducted in the manner contemplated under Rule 101(b)(10), as well as underwritings executed pursuant to the so-called Section 4 (1½) exemption from registration under the Securities Act, fall within the permitted underwriting activities contemplated in the Proposed Rule.

In addition, the exemption for underwriting activity requires that the activity be designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties. In many conventional underwritten offerings, underwriters will market the offerings to clients, customers and counterparties prior to the time at which the underwriters formally commit to purchase or underwrite such offerings, thus enabling the underwriters to effectively assess the expected near-term demands of clients, customers and counterparties. However, certain underwritten offerings – for example, "bought deals"[84] – do not contemplate any pre-commitment marketing activity. Underwriters conducting bought deals uniformly intend to purchase or underwrite only an amount of securities that they reasonably expect to represent the near-term demands of clients, customers and counterparties. Stated differently, underwriters conducting bought deals uniformly intend to purchase or underwrite only an amount of securities they expect to be able to re-sell to clients, customers and counterparties in the near term. Nevertheless, because there is no related pre-commitment marketing to clients, customers and counterparties, the underwriters would lack the pre-offering indications of interest and other data typically available in a traditional underwriting, thus increasing the possibility they may misjudge the potential demand for the offered securities. We request that the

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[83] Specifically, the following are exempted: "[t]ransactions in securities eligible for resale under Rule 144A(d)(3) [under the Securities Act of 1933, as amended (the 'Securities Act')] . . . , or any reference security, if the Rule 144A securities are offered or sold in the United States solely to: (i) Qualified institutional buyers, as defined in Rule 144A(a)(1) . . . , or to offerees or purchasers that the seller and any person acting on behalf of the seller reasonably believes are qualified institutional buyers, in transactions exempt from registration under § 4(2) of the Securities Act or Rule 144A or Rule 501 through Rule 508 under such Act; or (ii) Persons not deemed to be 'U.S. persons' for purposes of Rule 902 [under the Securities Act], during a distribution qualifying under paragraph (b)(10)(i) of [Rule 101]." SEC Reg. M Rule 101(b)(10).

[84] A "bought deal" is a transaction in which the banking entity acts as principal without engaging in related pre-marketing.

Agencies confirm that offerings executed in good faith as "bought deals" fall within the permitted underwriting activities contemplated in the Proposed Rule.

Further, banking entities that provide borrowers with bridge financing often require that a borrower agree to issue debt securities, at the banking entity's request and timing, to convert the bridge loan into debt securities. This is an important credit risk mitigation mechanism, providing the banking entity with an ability to reduce or eliminate credit exposure to the borrower. Sales of the newly issued debt securities are typically conducted via an underwritten offering. While it is uniformly the intention of a banking entity conducting such a debt securities offering to sell all of the offered securities as soon as it is able, if market conditions are sub-optimal or marketing efforts are not entirely successful, the banking entity may be required to hold some or all of the debt securities for a period of time. We request that the Agencies confirm that debt securities issued to replace outstanding bridge loans, in the circumstances contemplated in this paragraph, be classified in the same manner as the bridge loans themselves under the Proposed Rule (i.e., not as "covered financial positions") or, alternatively, confirm that these underwritten offerings of debt securities fall within the permitted underwriting activities contemplated in the Proposed Rule.

The risk-mitigating hedging exemption should adopt an enterprise-wide risk management approach rather than a transaction-by-transaction approach.

As the Agencies are fully aware, hedging activities are essential to the safety and soundness of banking entities' operations and constitute a vital component of the manner in which they manage risk. In recognition of this critical role, Section 13 provides an exemption for "[r]isk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings."[85] The Proposed Rule, however, narrows the scope of the exemption by requiring, among other things, that the purchase or sale of the hedge: (i) hedges or otherwise mitigates one or more specific risks, (ii) is reasonably correlated to the risks the purchase or sale is intended to hedge, and (iii) is subject to continuing review that it remains reasonably correlated to the risks it is intended to hedge. We are concerned that the transaction-by-transaction approach under the Proposed Rule will impair the ability of banking entities to effectively manage risk.

We urge the Agencies to adopt an alternative approach to the risk-mitigating hedging exemption that would instead allow banking entities to properly manage their enterprise-wide risk by requiring trading units to comply with internally established risk limits. These trading units should be reviewed at an activity level rather than a transaction-by-transaction level because individual analysis of each transaction would be costly and burdensome and would not produce the added benefit of better risk management. Furthermore, the stringent requirements set forth in the Proposed Rule, although

[85] BHC Act §13(d)(1)(c).

appropriate for identifying risk-mitigating hedging in some circumstances, could also prevent valid risk-mitigating hedging activities that are necessary to preserve the safety and soundness of banking entities. Flexibility must be preserved so that new and unprecedented risks may be hedged through appropriately innovative ways that may not be within the strict confines of the Proposed Rule's requirements. Traders who engage in beneficial activities such as risk-mitigating hedging should not be subjected to second guessing of each of their trading decisions. Instead, banking entities should be allowed to presume hedging activities are proper and appropriate unless given reason to believe otherwise. Although the Agencies may be concerned with internal compliance, this problem could be resolved through bank examinations and reporting metrics, as discussed in other parts of this letter. We believe that this approach would allow banking entities to properly manage risk, while also giving the regulators the ability to ensure hedging activities are proper without creating burdensome restrictions that impede proper hedging and add little additional value.

The enterprise-wide approach to the risk-mitigating hedging exemption would also take into account existing risk management systems used by banking entities. Banking entities that engage in market trading are already subject to a number of risk management requirements associated with frameworks such as the market risk capital rule and the CAMELS rating system. An enterprise-wide approach would allow banking entities to build upon their existing knowledge and systems, which would be both more economically efficient and more effective as a result of longstanding experience and expertise. We urge the Agencies to create a final framework that would allow banking entities to develop and improve upon their current risk management systems rather than require banking entities to dismantle these existing risk management structures and replace them with entirely new compliance regimes.

APPENDIX B

The exemption for permitted trading in government obligations should be expanded to include Canadian sovereign debt and other non-U.S. sovereign debt.

Section 13(d)(1)(A) of the BHC Act provides an exemption from the Volcker Legislation's proprietary trading restrictions for the purchase or sale of obligations of the United States or any agency thereof (the "U.S. Government Obligations Exemption"). Proposed Rule Section __.6(a) adds the obligations of "any state or any political subdivision thereof" to the exemption. Our primary concern with the limited scope of this exemption relates to its impact upon banking entities' U.S. operations, activities, safety and soundness and, therefore, upon U.S. and global financial markets, particularly given, among other things, the (i) interconnectedness of the global financial markets and (ii) critical role trading in government securities plays in national economies and in the treasury activities of financial institutions and commercial companies. We urge the Agencies to include the Canadian equivalents of these government obligations in the exemption to proprietary trading for the reasons set forth below. We also acknowledge and fully support the arguments submitted on this topic by Allen & Overy LLP on behalf of RBC and other Canadian banks.

We believe that a failure to exclude Canadian sovereign debt and other non-U.S. sovereign debt, among other things, potentially threatens the systemic stability of the global financial system, inappropriately violates principles of international comity and improperly interferes with the primary regulatory and supervisory responsibilities of foreign regulators.[86] Such discrimination also risks inciting foreign regulatory retaliation and protectionism. In fact, Michel Barnier, the European Commissioner for the Internal Market and Services, responded to the Volcker Legislation by stating, "[W]e can't accept extraterritorial consequences or Europe will be tempted to do the same thing. The Commission is concerned that the planned 'Volcker Rule', aimed at preventing banks from trading with their own capital, would hamper U.S. banks' ability to buy and sell European sovereign bonds on behalf of customers, reducing liquidity in those markets." [87]

Furthermore, the same policy reasons underlying promulgation of the U.S. Government Obligations Exemption justify expansion of this exemption to include non-U.S. government obligations. In this regard, the necessity for the U.S. Government Obligations Exemption has been well documented, including in the initial Senate Banking Committee hearing on the implications of the Volcker Rule on February 4, 2010. Testimony by Professor Hal S. Scott highlighted that "[f]orced reductions in this

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[86] *See, e.g.*, Office of the Superintendent of Financial Institutions Canada ("OSFI") Volcker Rule Comment Letter, Dec. 28, 2011 (the "OSFI Letter"); Government of Japan Financial Services Agency/Bank of Japan Volcker Rule Comment Letter, Dec. 28, 2011.

[87] Francesco Guerrera, Tracy Corrigan and Simon Nixon, EU Red-Flags "Volcker Rule", Wall St. J., January 27, 2012, at C1.

inventory [of Treasuries] under the Volcker Rule would drain liquidity from important Government funding markets and entail higher borrowing costs for the U.S. Government and its sponsored entities, negatively impacting economic recovery." [88] Professor Scott noted that even the Glass-Steagall Act recognized the "linkage between liquidity in Government debt markets and proprietary trading by banks in Government securities, providing for an exception authorizing banks to deal in, underwrite, and purchase for their own account securities issued by the U.S. Government."[89]

As reflected in comments made by various non-U.S. regulators, agencies and other financial institutions on the Proposed Rule, preservation of the markets for non-U.S. government obligations is important not only to other jurisdictions but to the global economy as a whole, the strength and stability of which inevitably affects the U.S. economy. For example, OSFI, in commenting upon the narrowness of the U.S. Government Obligations Exemption, stated that it "would not wish to see U.S. regulators taking actions that may enhance the stability of their financial system at the cost of undermining the stability of other systems around the world."[90] OSFI also urged the Agencies to be "mindful of the fact that U.S. financial institutions and markets (and their supporting infrastructure) are deeply connected to the broader global financial system." In addition, the Financial Services Agency Government of Japan and the Bank of Japan have jointly indicated in commenting upon the narrowness of the exemption that the "Bank of Japan's money market operations will be adversely affected.... [They] are concerned that such developments could occur on a global scale. This might exert extremely negative pressures on sovereign bond markets worldwide through reduced liquidity and a rise in volatility. Such a situation would be particularly worrisome under the current financial market condition."[91]

We maintain that it would be an appropriate use of the Agencies' authority under BHC Act Section 13(d)(1)(J) to adopt a general exemption of government obligations of Canada (and its political sub-divisions and agencies) as well as other non-U.S. governments on the basis that such an exemption would meet the prudential requirements set forth in Section 13(d)(2). Specifically, we submit that such permitted trading would not result in material conflicts of interest and would not result in material exposure to

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[88] *Examining the Implications of the "Volcker Rules" for Financial Stability: Hearing Before the S. Committee on Banking, Housing, and Urban Affairs*, 111th Cong. (2010) (statement of Hal S. Scott, Nomura Professor of International Financial Systems at Harvard Law School and Director of the Committee on Capital Markets Regulation).

[89] *Id.* (citing 12 U.S.C. §24 (Seventh), which provides that "[t]he limitations and restrictions herein contained as to dealing in, underwriting, and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof.").

[90] OSFI Letter, at 2.

[91] FSA/BOJ Letter, at 4.

high-risk assets or high-risk trading strategies.[92] In fact, exempting non-U.S. government obligations will facilitate risk mitigation through asset diversification. Such expansion would also facilitate satisfaction of Basel III liquidity obligations. Basel III will require banks to hold liquid assets, such as government securities, to meet certain liquidity targets. Prior to the adoption of the Volcker Legislation, banks were permitted to hold a diversified portfolio of these obligations in order to manage their concentration exposure. Application of the Proposed Rule would create significant hurdles for banks by forcing them either to hold exclusively U.S. government obligations or to rely on exemptions (such as the "solely outside of the United States" exemption, the liquidity management exemption or the market making exemption) that each contain specific limitations and impose a more significant compliance burden. Forcing reliance on these limited exceptions may carry unintended consequences and (in the case of the solely outside the United States exemption) may not be available depending on the bank's status.

As we have argued above, we believe that the Agencies should adopt a general exemption with respect to the trading in Canadian sovereign debt as well as certain other non-U.S. sovereign debt. If the Agencies do not adopt the exemption of all non-U.S. sovereign debt we advocate above, then we alternatively suggest the Agencies exempt non-U.S. government securities by using the following approach. First, banking entities and their affiliates should be permitted to trade freely in the securities of the home country of their parent institution. Second, banking entities should be permitted to trade freely in the government securities of their host countries (*i.e.*, the jurisdiction where their branches or affiliates are physically located). This approach, while still having some extraterritorial impact, would be less intrusive upon the markets of the countries in which the banking entities primarily operate. In addition, as we already argue above, non-U.S. government securities should be exempt to the extent required in light of the United States' treaty obligations (e.g., Canadian government securities pursuant to NAFTA and CFTA). Further, to the extent that the Agencies expand the scope of the U.S. Government Obligations Exemption, they should likewise expand the scope of the exemptions for non-U.S. government securities. We support, for example, an expansion of the exemption to include derivatives, which are a key component of the U.S. and other sovereign debt markets. This argument is further developed in the sections below.

The Agencies should revise the Proposed Rule to expand the government obligations exemption to include state and municipal and agency obligations as well as their non-U.S. equivalents.

The Notice asks whether the Agencies should adopt an exemption for proprietary trading in state or municipal agency obligations in addition to the Proposed Rule's existing exemption for the obligations of any "State or any political subdivision thereof" from the

[92] *See* BHC Act §13(d)(2)(A)(i)-(ii).

prohibition on proprietary trading.[93] We submit that the Agencies should adopt such additional exemptions for the reasons described below.

An exemption from prohibited proprietary trading that would exclude state and municipal agency obligations while permitting equivalent non-agency obligations draws an arbitrary distinction that serves little public utility. Approximately half of the current municipal market is comprised of obligations of states and municipalities themselves. The other half of the market is primarily made up of revenue bonds issued by state and municipal agencies, which are sometimes sold as tender option bonds. These revenue bonds support essential public services for the community. State and municipal agency obligations, among other things, fund important municipal activities, such as hospitals, sewage treatment plants and other industrial development facilities. We do not see any justification for differentiating the treatment of these types of agency obligations from other state or municipal government obligations. Indeed, we note that under the 1934 Act, the definition of "municipal securities" in Section 3(a)(29) includes not only the obligations of a state or any political subdivision thereof, but also "any agency or instrumentality of a State or any political subdivisions thereof." Additionally, at least in some cases, the state or municipality may simply offer the obligation itself rather than through an agency, using the same revenue from whatever was being funded to pay off the obligation. So, while essentially the same economically, the deal would have to be restructured simply to comply with the Proposed Rule.

Moreover, as the Proposed Rule exempts obligations of U.S. agencies,[94] we see no public policy reason for exempting obligations of federal agencies but not state and municipal agencies. Just as federal agencies seek to meet their financing needs in order to carry out their purposes and objectives, state and municipal agencies also issue securities as a means to fulfill their duties to the public. Government agencies at all levels of government serve important—sometimes critical—functions in society and we encourage the Agencies to facilitate these public services by expanding the proprietary trading exemption to state and municipal agency obligations, including tender option bonds.

Finally, trading in state and municipal agency obligations poses little risk to the safety and soundness of banking entities and the financial stability of the United States. Instead, in the absence of an exemption for state and municipal agency obligations, liquidity contraction is almost certain to follow due to decreased initial demand for positions that would be difficult to exit, which would frustrate the agencies' financing efforts. Even beyond exiting initial positions, liquidity would continue to be constrained for state and municipal agencies because the markets in which their obligations sell and trade already tend to be fragmented, and banking entities present a common and important source of liquidity. Further, because agency obligations represent a large portion of the state and municipal obligations market, new restrictions thereon may lead to broad disruptions and

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[93] Proposed Rule § __.6(a)(1)(iii).

[94] Proposed Rule § __.6(a)(1)(i).

price adjustments in the remaining state and municipal obligation markets. Hence, we believe that the Proposed Rule generates new problems and does not prevent any significant harms, as agency obligations are generally sound investments. Indeed, we believe allowing the trading in state and municipal agency obligations, including tender option bonds, would "promote and protect the safety and soundness of the banking entity and the financial stability of the United States" as required by BHC Act Section 13(d)(1)(J). Furthermore, we would assume that any such exemption would extend to non-U.S. equivalents, for reasons similar to those set forth above in relation to the U.S. Government Obligations Exemption.

The Agencies should revise the Proposed Rule to expand the exemption for foreign exchange and U.S. government securities to include trading in futures and derivatives that relate to these exempted instruments.

The Legislation contains provisions that allow trading in a number of instruments, including foreign exchange, as well as U.S. government securities, by excluding such instruments from the definition of "covered financial position" or creating an exemption for trading therein. These exclusions and exemptions are well founded given that banking entities have long traded in foreign exchange and government securities as part of their core business. However, frequently the most efficient way to take a position in such an instrument, or to hedge a position in such an instrument, is to enter into a derivative transaction. Nevertheless, the Proposed Rule treats futures and derivative transactions in excluded and exempted instruments as fully subject to the prohibitions on proprietary trading. Indeed, the Proposed Rule would even treat U.S. Treasury futures and forward trades in excluded or exempted instruments as proprietary trading. By doing so, the Proposed Rule effectively eviscerates the exclusion for foreign exchange and substantially undercuts the exemption for trading in U.S. government securities, given the deeply interconnected nature of the markets for these financial products and their related futures and derivatives instruments. We urge the Agencies to extend exemptive relief to all forward transactions, futures and derivative transactions related to these exempted instruments.

We recognize that, in many instances, forward, futures and derivative transactions would qualify for the risk-mitigating hedging exemption; however, it would be a misperception of the current market to conclude that forward and derivative transactions are used exclusively, or even primarily, in hedging transactions. The reality is that futures, derivatives and cash instruments are used to establish investment positions as much as they are used to offset previously taken cash positions. The cash, futures and derivatives markets are largely regarded as a single integrated market, in which choice of product is based on factors such as which instrument offers the better price or more closely aligns to the specific investment or trading needs of the market participant.

By treating derivatives differently from their underlying instruments, the Proposed Rule draws an artificial distinction that would result in decreased liquidity. In this regard, limiting the permitted activity to only the underlying cash instruments would

significantly impede the activity permitted by Congress in relation to government securities and frustrate banking entities' ability to satisfy customer demand. This, in turn, would drive up U.S. and foreign government funding costs through contraction and impair the efficiency of currency exchange markets. In doing so, it could also compromise the safety and soundness of affected banking entities and the financial stability of the United States and interconnected markets around the world. Finally, we note that because we believe that the Agencies should (and are obligated by treaty to) extend the exemption for trading in U.S. government obligations to Canadian Sovereign Obligations, as discussed immediately above, forwards and derivatives on such instruments (along with non-U.S. government securities for international comity purposes) should also be excluded for the same reasons set forth herein.

APPENDIX C

The definition of "covered fund" captures certain entities that pose little risk to the U.S. financial system, including securitization conduit vehicles.

The purpose of this Appendix C is to respond specifically to the request for comment (Question 298 of the Proposed Rule) on the appropriateness of the manner in which the Agencies are proposing to implement Section 13(g)(2) of the Volcker Rule, which is the Rule of Construction that provides that the Volcker Rule is not to be "construed to limit or restrict the ability of banking entities or nonbank financial companies … to sell or securitize loans…."

The Volcker Rule seeks to define generally the types of activities in which banking entities and nonbank financial companies[95] are prohibited from engaging by identifying the central policy objectives of the Volcker Rule. Those objectives are (i) to prohibit high-risk proprietary trading by banks and (ii) to limit the systemic risk of such activities by systemically significant nonbank financial companies.[96] To carry out these objectives, the Volcker Rule prohibits proprietary trading engaged in by banks directly for their own trading accounts (the "proprietary trading activities") as well as their sponsorship of or investment in hedge funds and private equity funds (the "covered funds activities"), all subject to several enumerated exceptions. Recognizing during the legislative sessions that produced the Dodd-Frank Act the difficulty (if not, impossibility) of enumerating specific activities that posed these risks, Congress delegated the responsibility for implementing the policy-based prohibitions of the Volcker Rule to the Agencies through the development and adoption of regulations. To assist the Agencies with this significant task, Congress commissioned the FSOC Study.

In crafting the Proposed Rule, the Agencies faced the enormous challenge of implementing these prohibitions while at the same time "[p]reserv[ing] the ability of banking entities to continue to structure their businesses and manage their risks in a safe and sound manner, as well as to effectively deliver to its clients the types of financial services that Section 13 [of the BHC Act] expressly protects and permits."[97] We appreciate the daunting task the Agencies had in preparing the Proposed Rule and commend them for their efforts. We appreciate particularly their thoughtful questions and requests for comments, designed to prepare final rules and regulations that effectively implement the Volcker Rule's prohibitions and restrictions, without adversely affecting market liquidity or unduly constraining banks in their efforts to safely provide client-oriented financial services.

As more fully detailed within Sections I and II of this Appendix C, we respectfully submit our recommended paths for the Agencies to fully effectuate Congressional intent of the Volcker Rule

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[95] As used in the Volcker Rule, the term "nonbank financial companies" refers to those nonbank financial companies that may be designated by the Financial Stability Oversight Council to be supervised by the Board and subject to enhanced prudential standards.

[96] *See* 156 Cong. Rec. S5894 (July 15, 2010) (Remarks of Senator Merkley).

[97] Proposed Rule at page 9.

while giving full and equal effect to the Securitization Exclusion. We believe that the most effective way to do so is to:

- Create an exception in the definition of "covered funds" for securitization issuers which have the core characteristics of traditional securitizations.[98] In Appendix CI, we propose a definition of "Securitized Asset Fund", together with related definitions, which incorporates these characteristics. The proposed exception would result in the securitization activities of such an entity (as described in the proposed definition) being exempt from the prohibited covered funds activities in Section 13(f)(1) of the BHC Act; OR

- If the Agencies prefer to work within the construct of the Proposed Rule, we request that (i) the modifications described in Section II of this Appendix C be made to the provisions in the Proposed Rule that permit securitization activities and (ii) permitted securitization activities be exempted from new Section 13(f)(1) of the BHC Act, as implemented in proposed Section __.16(a)(1) of the Proposed Rule, which are more fully detailed in Appendix CII.

Background:

Section 13(a)(1)(B) of the BHC Act prohibits a banking entity from "acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or a private equity fund." A "hedge fund" or "private equity fund", interchangeably called a "covered fund" in the Proposed Rule,[99] is defined very broadly in the Volcker Rule (new Section 13(h)(2) of the BHC Act) to be "an issuer that would be an investment company under the 1940 Act [citation omitted], but for Section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine." Taken literally, these two provisions could be read to restrict a banking entity from engaging in any securitization transaction with an issuer fund if that banking entity has any equity interest in, or a sponsorship role with respect to, that fund and that fund relies on the private placement exemptions of Section 3(c)(1) or 3(c)(7) of the 1940 Act.

This restrictive reading, when juxtaposed against the Securitization Exclusion included by Congress in the Volcker Legislation, seems contrary to Congress' intent. Congressional intent was recognized by the Agencies in the Proposed Rule, as evidenced by §_.13(d),[100] which is

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[98] Those characteristics are incorporated into the definition of "Securitized Asset Fund" proposed in Appendix CI and include, among other things, (i) that the compensation of the owners, managers or sponsors not be incentive-based and (ii) that the fund has a predominant buy and hold investment strategy. The absence of these characteristics is, as indicated in the FSOC Study, indicative of hedge funds or private activity funds. *See* FSOC Study at page 62.

[99] As described in the Proposed Rule at pages 112-113: Given that the statute defines a "Hedge fund" and "Private equity fund" synonymously, the proposed rule implements this statutory definition by combining the terms into the definition of a "covered fund."

[100] Section __.13(d) of the Proposed Rule provides:

included specifically for the purpose of implementing the Securitization Exclusion.[101] Further, the Agencies seem to recognize the conflict inherent in some of the Volcker Rule's prohibitions (such as characterizing all securitization issuers as covered funds and all securitization activities as prohibited activities) in the section of the Proposed Rule that permits certain covered fund activities through the Agencies' exercise of their discretionary authority. Congress authorized the Agencies to permit covered fund activities that they determined to be safe and sound and to promote and protect the safety and soundness of banking entities and the financial stability of the Unites States.[102] For example, in §_.14(a)(v) of the Proposed Rule, the Agencies characterized the acquisition by a banking entity of an equity interest in certain securitization issuers as such permissible activity.[103]

(d) Loan securitizations. The prohibition contained in §__.10(a) does not apply with respect to the acquisition or retention by a covered banking entity of any ownership interest in or acting as sponsor to, a covered fund that is an issuer of asset-backed securities, the assets or holding of which are solely comprised of:

(1) Loans;

(2) Contractual rights or assets directly arising from those loans supporting the asset-backed securities; and

(3) Interest rate or foreign exchange derivatives that:

(A) Materially relate to the terms of such loans or contractual rights or assets; and

(B) Are used for hedging purposes with respect to the securitization structure.

[101] Proposed Rule at page 147.

[102] Proposed Rule §_.14(a).

[103] Section __.14(a)(v) of the Proposed Rule is an exception to the prohibition in Section __.10(a), which prohibits a banking entity, as principal, directly or indirectly, from acquiring or retaining any ownership interest in, or sponsoring, a covered fund. It provides, in pertinent part:

(a) The prohibition contained in §__.10(a) does not apply to the acquisition or retention by a covered banking institution of any ownership interest in or acting as sponsor to:

. . .

(v) A covered fund that is an issuer of asset-backed securities described in §__.13(d), the assets or holdings of which are solely comprised of:

(A) Loans;

(B) Contractual rights or assets directly arising from those loans supporting the asset-backed securities; and

(C) Interest rate or foreign exchange derivatives that:

(i) Materially relate to the terms of such loans or contractual rights or assets; and

(ii) Are used for hedging purposes with respect to the securitization structure.

We believe that the definition of "hedge fund and private equity fund" is intended to identify a type of issuer fund commonly referred to in the marketplace as a "hedge fund" or a "private equity fund" or that is engaged in the business of a "hedge fund" or "private equity fund". The definition was not intended to define the universe of issuer funds with which banking entities and nonbank financial companies are prohibited from engaging in activities solely by virtue of sharing a characteristic that relates to their exemption from registration as an investment company. Our belief is supported by both the legislative history of the Volcker Rule and the FSOC Study. Congressman Frank himself said, in response to a colleague's request for confirmation that the Volcker Rule won't "deem" all subsidiaries or joint ventures that banks own and use to hold investments to be private equity or hedge funds: "we don't want these overdone. We don't want there to be excessive regulation.... The distinction ... is very much in this bill, and we are confident that the regulators will appreciate the distinction, maintain it...."[104] Indeed, in the FSOC Study, the FSOC's members cautioned the Agencies to "carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in 3(c)(1) and 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule" and further, outlined for the Agencies the factors to be considered in identifying which entities have the characteristics of hedge funds or private equity funds. These characteristics include: (i) is the compensation of the owners, managers or advisors to the fund based on fund performance (including the gains or losses on the funds assets/investments)?; (ii) what is the trading and investing strategy of the fund?; (iii) is the fund highly leveraged?; (iv) are there many unaffiliated investors?[105] In the view of the FSOC, incentive compensation, volatility of asset performance and high leverage are indicia of hedge and private equity funds, and the kind of speculative behavior the Volcker Rule is intended to prohibit.

It is evident that Congress directed the Agencies to be guided by the findings of the FSOC Study in crafting regulations that define "hedge funds and private equity funds", called, in the Proposed Rule, "covered funds". It is further evident that Congress intended the Agencies to be mindful of the two-fold principles underlying the Volcker Legislation, namely, prohibiting banks from engaging in high-risk activities that are divorced from serving the needs of their customers and that put the banks' capital at risk, while at the same time protecting and promoting a broad array of banking activities that are low-risk and provide client-oriented financial services. The only issuer funds and activities (whether related to securitizations or not) that are properly scoped into the prohibited activities are those activities that provide little or no service to bank clients, jeopardize the capital base of insured depositary institutions or pose a threat to the safety and soundness of the financial system. To state the obvious, not every issuer fund or activity poses the risks to the banking system and the economy that the Volcker Legislation is designed to protect against. Further, prohibiting certain types of relationships between banking entities and issuer funds of the type defined in Section 13(h)(2) would not produce the intended result of promoting and enhancing the safety and soundness of the financial system and the financial stability of the United States. Rather, it would eliminate or substantially reduce the viability of certain vital consumer and corporate credit products, such as capital markets securitization activities, that are traditional client-driven capital markets products intermediated by banking

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[104] *See* 156 Cong. Rec H5223 (June 30, 2010) (Remarks of Congressman Himes and Congressman Frank).

[105] *See* FSOC Study at page 62.

entities. Such products are critical liquidity management tools for the extension of corporate and consumer credit and are pillars of a healthy, stable and sound economy.

We urge the Agencies to fully effectuate the intent of Congress evidenced by the Securitization Exclusion. We believe that the most effective way to do so is to exclude from the definition of "covered funds" (and consequently, the prohibited covered funds activities in Section 13(f)(1) of the BHC Act) securitization issuers which have certain core characteristics (as more fully discussed below). In Appendix CI, we propose a definition of "Securitized Asset Fund" which incorporates these characteristics. If, however, the Agencies prefer to work within the construct of the Proposed Rule, we respectfully request, in order to implement fully Congress' intent, that (i) the modifications described in this Appendix C be made to the provisions in the Proposed Rule that permit securitization activities and (ii) permitted securitization activities be exempted from new Section 13(f)(1) of the BHC Act, as implemented in proposed Section __.16(a)(1) of the Proposed Rule.

I. The Securitization Exclusion is best implemented by the Exclusion of "Securitized Asset Funds" from the Definition of "Covered Funds" in the Proposed Rule

Traditional securitizations, as well as securitization products yet to be developed to reflect changing business needs that are designed in a manner consistent with the hallmark characteristics of traditional securitizations,[106] are prima facie intended by the Congress to be scoped out of the prohibited covered funds activities. In explaining to fellow senators the provisions of the Volcker Legislation just days before the passage of the Dodd-Frank Act, Senator Merkley elaborated: "The definition of proprietary trading ... covers a wide range of financial instruments.... Pursuant to the rule of construction in subsection (g), paragraph (2) [that is, the Securitization Exclusion], the definition should not generally include loans sold in the process of securitizing; however, it could include such loans if such loans become financial instruments traded to capture the change in their market value."[107] Traditional securitizations play a vital role in the economy and are a traditional business of banks, as capital markets intermediaries that provide a cost effective means of financing for U.S. businesses and an important and highly liquid product for U.S. investors, including money market funds. For those sectors of the securitization market that involved excessive risk or did not perform well during the financial crisis, the Volcker Legislation or other sections of the Dodd-Frank Act contains provisions that on their own, or through regulations, are intended to prescribe corrective actions.[108]

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[106] Those characteristics are incorporated into the definition of "Securitized Asset Fund" proposed in Appendix CI and are enumerated in note 5 *supra*.

[107] 156 Cong. Record S5895 (July 15, 2010).

[108] Among these provisions are: Section 941 of Dodd-Frank (Regulation of Credit Risk Retention) and the proposed implementing regulations thereunder, entitled "Credit Risk Retention", which are designed to align the incentives of issuers and originators with investors of asset-backed securities and to encourage the applications of sound underwriting standards by the originator and issuer in connection with the assets that are securitized; new Rule 15Ga-1 under the Securities Exchange Act of 1934, as amended, "Disclosure for Asset- Backed Securities Required by Section 943 of The Dodd-Frank Wall Street Reform and Consumer Protection Act", which requires securitizers to disclose fulfilled and unfulfilled repurchase requests relating to the assets that are securitized in order

We acknowledge that the Agencies have included provisions in the Proposed Rule that define certain securitization issuers and activities to be permitted covered funds and permitted covered funds activities – in one case, with the intention to implement the Securitization Exclusion[109] and in the other, in an effort to provide a companion exclusion to the Securitization Exclusion, by permitting banks to acquire and retain ownership interests in certain securitization issuers that the banks do not organize or offer[110] (collectively, the "Proposed Rule Securitization Exclusions"). However, the Proposed Rule Securitization Exclusions are insufficient to permit the array of traditional securitizations, and securitizations with the characteristics of traditional securitizations, from being carried on so as to fully serve the needs of bank clients and to fully promote sound and safe banking practices that support the United States economy. There are two major reasons for this. First, the list of assets that a securitization issuer is permitted to own and the enumerated activities that a securitization issuer is permitted to engage in are too narrow.[111] Second, and more significantly, the provisions of proposed §_.16(a)(1), which implement Section 13(f)(1) of the BHC Act, prohibit a banking entity from entering into any "covered transactions" (as defined in Section 23A of the Federal Reserve Act) with any covered funds (which includes securitization issuers relying on 3(c)(1) and 3(c)(7) of the 1940 Act, regardless of whether their securitization activities would be permissible under the Proposed Rule Securitization Exclusions) that it organizes or offers or to which it provides investment advice or investment management services (the "Covered Funds Transaction Prohibition"). This would effectively eliminate a substantial portion of the very securitization activities carried on by banks that the Proposed Rule Securitization Exclusions are designed to preserve. We are convinced that Congress and the Agencies could not have intended this result.

Therefore, we urge the Agencies to effectively implement the Securitization Exclusion by properly narrowing the definition of "covered funds" to exclude securitization issuers which have certain core characteristics. Such securitization issuers are clearly and easily distinguishable from private equity and hedge funds, and even from so-called securitization vehicles that most objective observers would view to have many of the properties of hedge funds and/or private equity funds.[112] Congressman Frank was confident that the Agencies would appreciate the

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to allow investors to identify asset originators with clear underwriting deficiencies; and Section 621 of Dodd-Frank and the proposed implementing release thereunder, which would prohibit parties (transaction parties) which have substantial roles in assembling and selling asset-backed securities from engaging in transactions that would result in or involve material conflicts of interest between the transaction parties and investors in connection with the asset-backed securities transaction.

[109] Proposed Rule at page 147.

[110] See Proposed Rule at page 151, in which the Agencies describe Section __.14(a)(v) as "augment[ing] the authority regarding the sale and securitization of loans available under §__.13(d) of the proposed rule."

[111] See the definition of "Loan" in Section __.2(q) of the Proposed Rule and the related discussion on page 45.

[112] Indeed, the Commission, in adopting the new reporting form (Form PF) for private investment advisers under the Investment Advisers Act of 1940, recognized a distinction between "securitized asset funds" and true "hedge funds" and "private equity funds". Form PF has been adopted by the Commission to implement Section 402 of the Dodd-Frank Act, which requires certain investment advisers to report on their "private funds" activities. Section 402 defines "private funds" in a manner similar to the "covered funds" definition in the Volcker Rule, that is, "any issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act." The Commission divided private funds into subcategories, with their

distinctions.[113] as was Paul Volcker, the former Chairman of the Federal Reserve for whom Section 619 of the Dodd-Frank Act is named. In his statement before the Committee of Banking, Housing and Urban Affairs of the United States Senate on February 2, 2010, he observed: "the functional definition of hedge funds and private equity funds that commercial banks would be forbidden to own or sponsor is not difficult. As with any new regulatory approach, authority provided to the appropriate supervisory agency should be carefully specified. It also needs to be broad enough to encompass efforts sure to come to circumvent the intent of the law." He also observed that only a handful of commercial banks in the United States have engaged heavily in high-risk activities, and that most U.S. commercial banks have been engaged in meeting customer needs in ways that are both potentially profitable and properly within the province of commercial banks, including originating and securitizing mortgages and other credits under appropriate conditions and activities analogous to commercial lending.[114]

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respective definitions enumerating the significant and distinguishing characteristics of each. Among those subcategories are "hedge" funds", "private equity funds" and "securitized asset funds" and they are defined as follows:

Hedge fund: Any *private fund* (other than a *securitized asset fund*):

a. with respect to which one or more investment advisers (or *related persons* of investment advisers) may be paid a performance fee or allocation calculated by taking into account unrealized gains (other than a fee or allocation the calculation of which may take into account unrealized gains solely for the purpose of reducing such fee or allocation to reflect net unrealized losses);

b. that may borrow an amount in excess of one-half of its *net asset value* (including any *committed capital*) or may have gross notional exposure in excess of twice its *net asset value* (including any *committed capital*); or

c. that may sell securities or other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration).

Solely for purposes of this Form PF, any *commodity pool* about which you are reporting or required to report on Form PF is categorized as a *hedge fund*.

For purposes of this definition, do not net long and short positions. Include any borrowings or notional exposure of another person that are guaranteed by the *private fund* or that the *private fund* may otherwise be obligated to satisfy.

Private equity fund: Any *private fund* that is not a *hedge fund, liquidity fund, real estate fund, securitized asset fund* or *venture capital fund* and does not provide investors with redemption rights in the ordinary course.

Private fund: Any issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act.

If any *private fund* has issued two or more series (or classes) of equity interests whose values are determined with respect to separate portfolios of securities and other assets, then each such series (or class) should be regarded as a separate *private fund*. This only applies with respect to series (or classes) that you manage as if they were separate funds and not a fund's side pockets or similar arrangements.

Securitized asset fund: Any *private fund* whose primary purpose is to issue asset backed securities and whose investors are primarily debt-holders.

[113] 156 Cong. Record H5223 (June 30, 2010) (remarks of Congressman Frank).

[114] *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies before the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 2 (February 2, 2010) (testimony of the Honorable Paul Volcker, Chairman, President's Economic Recovery Advisory Board).

RBC shares Congressman Frank's confidence in the Agencies. We also endorse Mr. Volcker's view that the Agencies must find the right balance in defining those covered funds activities that put a bank's capital at risk, akin to the activities of a hedge fund or private equity fund, on the one hand, and those that share a 1940 Act exemption, but otherwise merely carry out traditional commercial bank, customer-oriented services, on the other.

To that end, as mentioned above, we recommend that the Agencies exclude from the definition of "covered fund" in Section __.10(b)(1) of the Proposed Rule certain securitization vehicles, and propose a definition of "Securitized Asset Fund" and related provisions to implement this exclusion. We include these definitions and related provisions on Appendix CI. Essentially, our proposal would, among other things, (i) define the types of assets a securitization issuer could hold, (ii) describe the types of activities that a securitization issuer could engage in, (iii) prohibit a securitization issuer from trading its assets for the primary purpose of recognizing gains or losses or realizing short-term arbitrage profits, and (iv) prohibit the sponsor or investment adviser or manager to a securitization issuer from receiving compensation with incentives based on the market value of the issuer's assets. In our view, the Securitized Asset Fund exclusion to the definition of "covered fund" is the appropriate manner in which to implement the Securitization Exclusion. We appreciate the Agencies' efforts to accomplish this result in the Proposed Rule Securitization Exclusions, but believe for the reasons described above that they are inadequate. We firmly believe that in recommending the changes described in this paragraph and in Appendix CI, the Agencies will be better aligned with Congressional intent. The Volcker Rule was not enacted to curtail beneficial securitization activities, but rather to provide the Agencies with authority to regulate those securitization issuer funds and activities which have proven overly risky to the financial system. These outcomes are critical to the promotion and protection of a strong and stable banking system and the recovery of the U.S. economy.

II. To Fully Implement the Securitization Exclusion, Modifications are Needed in the Proposed Rule.

For the reasons discussed above, we believe that the most straightforward and effective way in which to implement the Congressional intent evidenced by the Securitization Exclusion is to carve "securitized asset funds" out of the definition of covered funds. We cannot identify any protections in the Proposed Rule that are lost by such an approach.[115] However, we realize that the drafters of the Proposed Rule took a different path to implementation of the Securitization Exclusion. While we think it is the less efficient path, we are confident that with some modifications, the current Proposed Rule Securitization Exclusion can properly define those securitization issuers with which banking entities can engage in permissible covered funds activities.[116] This is, in our view, what the Agencies intended and attempted to do. We find

[115] For example, we note that if securitized asset funds are defined not to be covered funds, the prohibitions against "material conflicts of interest" contained in §__.17 of the Proposed Rule would not apply. If, however, a securitized asset fund were engaged in a securitization transaction, its related banking entity (when serving in certain capacities with respect to that securitization transaction) and related transactions would be subject to the material conflicts of interest prohibitions of Section 621 of the Dodd-Frank Act, which adds new §27B to the Securities Act of 1933, as amended, and Proposed Rule 127B to be promulgated thereunder.

[116] In order to fully implement the Securitization Exclusion, we believe it also necessary to construe the Covered Funds Prohibited Transaction as subject to that Securitizations Exclusion, as described below.

evidence of that intention both in the commentary in the Proposed Rule that clarifies what type of securitization issuer would not be a covered fund and in the Agencies' inquiries relating to those exclusions. In the commentary relating to the "Application of Section 13 of the BHC Act to Securitization Vehicles or Issuers of Asset-Backed Securities", the Agencies make clear that a securitization issuer that could rely on any exclusion or exemption from registration under the 1940 Act other than Section 3(c)(1) or Section 3(c)(7) would not be included in the definition of covered fund, even if that securitization issuer offered its securities in reliance on one of the 1940 Act's private placement exemptions. The drafters recognize that many securitization issuers do, or at least, could rely on Section 3(c)(5) of the 1940 Act or Rule 3a-7 thereunder for their exemption from registration as investment companies and express no concern in connection with such reliance about risky behaviors that could jeopardize the safety of the banks that sponsor them or own them. We agree that many securitization issuers of traditional asset-backed securities can rely on Section 3(c)(5) or Rule 3a-7, but we observe that many issuers of asset-backed securities that the markets regard as high-performing and low risk cannot. Business and consumer practices change and give rise to the need to finance new types of assets, such that the limitations of Section 3(c)(5) are too restrictive. And, in the nearly 20 years since Rule 3a-7 was proposed, certain securitization structures have evolved or new products created such that one or more of the technical requirements of that Rule cannot be satisfied. Examples of transactions that have become traditional securitizations, but that do not satisfy the requirements of either Section 3(c)(5) or Rule 3a-7, include: automobile and equipment lease transactions in which significant residual value of the automobiles or equipment is financed (cannot satisfy the primarily consist of "eligible assets" test of Rule 3a-7 because neither automobiles nor equipment is an "eligible asset"); asset-backed commercial paper programs do not typically have trustees (do not rely on the "current transaction" exemption from registration under the Securities Act of 1933, as amended, and therefore, pursuant to clause (a)(4) of Rule 3a-7, are required to have trustees); and simple municipal bond repackagings, most commonly referred to as "TOBs" or "tender option bonds" may fall outside the exemption provided by Rule 3a-7 because of concerns that TOBs may issue redeemable securities. It seems an anomalous result that securitization issuers which are owned or sponsored by the same banks would be treated differently under the Volcker Rule even though those securitization issuers own, sell and securitize assets of similar types and low risk profile, simply because one group of securitization issuers can satisfy the technical requirements of Rule 3a-7 and one cannot.

We believe that it is necessary to eliminate this anomaly in order to appropriately implement the Securitization Exclusion and give effect to the policy goals and intent of Congress. To do so, we propose that (i) the Proposed Rule Securitization Exclusions be modified in the way described below (assuming those modifications have been effected, the "Final Rule Securitization Exclusions") and (ii) the Covered Funds Transaction Prohibition be modified to exempt the Final Rule Securitization Exclusions. The reasons that, in our view, these actions are appropriate are covered in Part I of this Appendix C. To repeat them briefly in this Part II, the purpose of the Volcker Rule is to prohibit banks from engaging directly or indirectly, through affiliates or entities they sponsor, in excessively risky activities that do not support customer needs.[117]

[117] In the words of Senator Dodd, one of the sponsors of the Dodd-Frank Act. "the purpose of the Volcker rule is to eliminate excessive risk taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest." 156 Cong. Record S5905 (July 15, 2010).

Traditional securitizations and securitization products designed in a manner consistent with the hallmark characteristics of traditional securitizations are not the types of risky activities intended to be subject to the restrictions of the Volcker Rule.

We respectfully recommend that the Agencies make the following changes to the Proposed Rule Securitization Exclusions: (a) broaden the definition of "Loan" in Section __.2(q) of the Proposed Rule, (b) recognize in Section __.13(d) and __.14(a) that there are certain incidental assets that an issuer an issuer of asset-backed securities may hold and certain ancillary activities that issuer may properly engage in, (c) allow for securitizations that involve two or more tiers of issuers of asset-backed securities[118] and (d) allow for securitizations that involve repackaging of municipal securities. In Appendix CII, we include revisions of Sections 2(q) and .__13(d) (together with related definitions) that reflect these recommendations. Conforming changes would also need to be made in Section __.14(a).

We believe that the Covered Funds Transaction Prohibition should not apply to the Final Rule Securitization Exclusions. We feel strongly that to apply it to the Final Rule Securitization Exclusions would conflict with Congressional intent and the direction given to the Agencies in the Securitization Exclusion. We see no basis for applying the rule of construction in the Securitization Exclusion selectively. That is, if Congress meant to protect and promote the relationships between banks and issuers of safe and sound asset-backed securities, Congress must have intended the Agencies to promulgate rules that (i) allow banks to own and/or sponsor securitization issuers AND (ii) allow the types of transactions and activities between the parties that make the securitizations undertaken by those parties viable.

Moreover, giving effect to the Covered Funds Transaction Prohibition with respect to the Proposed Rule Securitization Exclusions would, for many securitization structures, result in the Volcker Rule and its implementing regulations leaving the parties unable to make use of permissible securitization structures. As currently set forth in the Proposed Rule, a bank can own or sponsor a securitization issuer that complies with the characteristics set forth in the Volcker Rule, but it cannot engage with that entity in the transactions and activities that are necessary to make that securitization issuer's securitization transactions viable or more credit-worthy.[119] We could understand this application of the Covered Funds Transaction Prohibition if

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[118] In Question 301 of the Proposed Rule, the Agencies asked commenters whether there was need for clarification in the rules for structures that are multiple-tiered, e.g., asset-backed commercial paper programs and auto lease titling trust and issuing trust structures (*See* Appendix CIII for diagram(s) that illustrate these multi-tiered structures). We interpret this question to mean that these types of transactions were intended to be permissible under Section __.13(d), and that the Agencies were asking for guidance as to appropriately provide for such structures in the final rules.

[119] An important example of a securitization program that would not be viable without its sponsoring bank's support is an asset-backed commercial paper program, in which investors [and rating agencies] require 100% liquidity support (which may take the form of an asset purchase agreement, a liquidity loan, a repurchase agreement or other similar arrangement) and a certain level of credit support (which may take the form of a letter of credit, asset purchase agreement or other similar arrangement), each typically provided by their sponsoring banks. The Agencies have recognized the importance and appropriateness of credit and liquidity support provided by the sponsoring banks in these programs and made such an arrangement a requirement of the proposed special risk retention option designed for structures involving asset-backed commercial paper. *See* the proposed rulemaking of the Agencies, the Federal Housing Finance Agency and the Department of Housing and Urban Development entitled "Credit Risk Retention" (March [10], 2011) issued pursuant to Section 941 of the Dodd-Frank Act at page 66.

the types of permissible securitization activities were themselves high risk. But given the limitations in the Proposed Rule Securitization Exclusions — the underlying principles of which we agree with – we can see no policy reason to apply the Covered Funds Transaction Prohibition to those transactions. Furthermore, what distinguishes the relationships between banks and their securitization vehicles which are permitted under the Proposed Rule (in which instances, the Covered Funds Transaction Prohibition would apply) from the relationships between those same banks and their securitization vehicles that rely on other exclusions or exemptions from the 1940 Act (to which cases, the Covered Funds Transaction Prohibition would not apply)? Do the activities of one group of relationships pose greater risks than the same activities by the others? The Agencies did not think so, or they would not have proposed Section __.13(d) or more significantly, exercised their discretion in Section __.14(a).

We rely again on the legislative history to support our view and that of the Agencies that the Volcker Rule was intended to prohibit banks from engaging, either directly or indirectly through their affiliated or sponsored entities, in risky market activities, and to re-focus the business of banks to safe and sound customer-based services. As Senator Merkley, in his remarks on the Covered Funds Transaction Prohibition stated:

> "the restrictions on proprietary trading and relationships with private funds seek to break the internal connection between a bank's balance sheet and taking risk in the markets, with a view towards reestablishing market discipline and refocusing the bank on its credit extension function and client services.... At times, the banks bailed out the funds...ultimately rely[ing] on taxpayers to bail them out.... The relationships that a banking entity maintains with and services it furnishes to its advised funds can provide reasons why and the means through which a firm will bail out an advised fund, be it through a direct loan, an asset acquisition or through writing a derivative [all "covered transactions" under Section 23A of the Federal Reserve Act]."[120]

In summary, the Covered Funds Transaction Prohibition is intended to prevent banks from engaging in transactions with entities that carry on risky business activities. Congress purposefully inserted the Securitization Exclusion in the Volcker Rule so that securitization activities, properly defined by the Agencies in the implementing regulations, would not be scoped into the prohibitions of the Rule. In the Proposed Rule, the Agencies made a good start at

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Additional examples of securitizations that would be either not viable or less credit-worthy without their sponsoring bank's support include: (i) TOBs programs, which depend on their sponsoring banks to provide the liquidity that investors rely on to purchase short-term securities backed by long-term municipal securities; (ii) many securitizations provide for sponsor/originator performance guaranties of the obligations of their related securitization issuers which also act as servicers of the securitized assets; (iii) in many securitizations, bank sponsors act as servicers of the securitized assets and often provide servicing advances with respect to late collections to the securitization issuers to smooth over the cashflows of the securities; and (iv) credit card securitizations require credit enhancement which, to be economically feasible, is sometimes provided in the form of a cash collateral loan from the sponsoring bank to the securitization issuer trust.

[120] 156 Cong. record S5898 (July 15, 2010).

so defining. We ask simply that the Agencies make the recommended modifications to the Proposed Rule so as to complete the direction that Congress gave them.

III. Conclusion

Once again, we commend the Agencies for having invited public comment on these critically important issues. We appreciate the serious consideration given by the Agencies to the need to balance the objectives of the Volcker Rule and to craft regulations that protect the financial stability of U.S. banks while promoting the appropriate business of banks and the stability of the U.S. economy. As discussed in greater detail in this Appendix C, however, we are convinced that, in implementing the Securitization Exclusion in the Volcker Rule, the Agencies did not fully effectuate the Congressional mandate. We believe that our proposal contained in Part I of this Appendix C is the most effective way to do so. If, however, the Agencies prefer to work within the parameters set out in the Proposed Rule, we feel confident that the recommended modifications to the Proposed Rule Securitization Exclusions and exemption of the Final Rule Securitization Exclusions from the coverage of the Covered Funds Transaction Prohibition (as discussed in Part II of this Appendix C) would also be a means to accomplish that result. Finally, we observe that the rule text language that we suggest in Appendices CI and CII reflects generally the implementation of the policies that we discuss in this Appendix C. We would expect that as the Agencies consider specific securitization products and their treatment under the Volcker Rule and its Securitization Exclusion, those provisions would need refinement. We would welcome the opportunity to meet with representatives of the Agencies to discuss how our proposed language might be revised to most effectively implement the policies discussed in this Appendix C as applied to all appropriate securitization issuers.

Appendix C-I

Securitization Asset Fund Exclusion

Modification to Section __.10(b)(1):

§ __.10(b)(1). Covered Fund means:

(i) An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act (15 U.S.C. 80a-3(c)(1) or (7)), other than a Securitized Asset Fund;

Related Definitions:

Securitized Asset Fund means (i) any entity which is engaged primarily in the business of acquiring, holding or owning Loans, financing the acquisition, holding or owning of such Loans through the issuance of asset-backed securities and repaying such asset-backed securities through the payments of principal of and interest on the Loans (and in activities supporting or related to the foregoing) or (ii) any special purpose vehicle which acts as an intermediary of an entity described in preceding clause (i);

Provided that:

(i) such entity may acquire, hold or own cash, cash equivalents and Eligible Assets as long as such Eligible Assets comprise no more than 10% of its total assets (based on book value);

(ii) the asset-backed securities of such entity are issued primarily to debt investors, other than any asset-backed or other securities issued to affiliates or subsidiaries of that entity;

(iii) the Loans and Eligible Assets held by such entity are not acquired or disposed of for the primary purpose of (a) recognizing gains or decreasing losses resulting from market value changes, or (b) realizing short-term arbitrage profits;

(iv) compensation for the management of such entity's Loan and Eligible Asset acquisition and disposition activities does not include incentives relating to market value of the Loans or Eligible Assets held from time to time;

(v) the Loans and Eligible Assets acquired by such entity are acquired, directly or indirectly, to facilitate, the sponsoring banking entity's client or customer businesses or financing needs;

(vi) the Loans and Eligible Assets held by such entity are not equity and the repayment of the asset-backed securities of such entity does not rely primarily on the ability to sell the Loans and Eligible Assets of such entity; and

(vii) the sponsor of such entity is subject to the risk retention and material conflicts of interest provisions contained in Dodd-Frank and the regulations promulgated thereunder.

For purposes of this definition, activities related to or supporting the primary business of a Securitized Asset Fund would include (i) acquiring credit and liquidity support for its asset-backed securities from any person (including an affiliate, sponsor or owner) as long as such support is on market terms, and (ii) interest rate and foreign currency hedges designed to protect an anticipated payment stream from the Loans and Eligible Assets.

Eligible Assets means assets, other than Loans, which, by their terms, convert to cash within a finite period of time.

Loan means (i) any loan, lease (including any lease residual), extension or credit, or secured or unsecured receivables, (ii) any note, bond or security collateralized and payable from pools of loans, leases (including Lease residuals), extensions of credit or secured or unsecured receivables, and (iii) any contractual rights arising from, or security interests or liens, assets, property guarantees, insurance policies, letters of credit, or supporting obligations underlying or relating to any of the foregoing.

Appendix C-II

Modifications to Proposed Rule Securitization Exclusions and Covered Funds Transaction Prohibition

Proposed Modifications to Section 13(d) (with conforming changes to be made to Section __.14(a)):

(d) Loan securitizations. The prohibition contained in § __.10(a) does not apply with respect to the acquisition or retention by a covered banking entity of any ownership interest in, or acting as sponsor to, a covered fund that is:

(A) an issuer of asset-backed securities (or special purpose vehicle which acts as an intermediary of an issuer of asset-backed securities), the assets or holdings of which are primarily comprised of:

(1) Loans, cash, cash equivalents and Eligible Assets;

(2) Contractual rights or assets directly arising from those Loans and Eligible Assets supporting the asset-backed securities; and high quality short term investments purchased with proceeds from the assets held by the issuer which mature no later than the date on which such proceeds are required to be paid to investors in the asset-backed securities; and

(3) Interest rate or foreign exchange derivatives that:

(i) Materially relate to the terms of such loans, asset-backed securities or contractual rights or assets; and

(ii) Are used for hedging purposes with respect to the securitization structure;

(B) an Eligible ABCP conduit that issues asset-backed securities, the assets or holdings of which are comprised of:

(1) Loans, cash, cash equivalents and Eligible Assets so long as Eligible Assets comprise no more than 10% of its total assets (based on book value);

(2) Contractual rights or assets directly arising from those Loans, Eligible Assets or asset-backed securities; and high quality short term investments purchased with proceeds from the assets described in (B)(1) which mature no later than the date on which such proceeds are required to be paid to investors in the asset-backed securities;

(3) Interest rate or foreign exchange derivatives that:

(i) Materially relate to the terms of such loans or contractual rights or assets; and

(ii) Are used for hedging purposes with respect to the securitization structure; and

(4) Contractual commitments providing for liquidity protection or credit enhancement between such ABCP conduit and its sponsor.

(C) an issuer of securities, the assets or holdings of which are solely comprised of:

(1) Municipal Securities;

(2) Contractual rights or assets directly arising from those Municipal Securities; any guarantee, insurance policy, letter of credit or other obligation supporting any Municipal Securities supporting such securities, and high quality short term investments purchased with proceeds from Municipal Securities which mature no later than the date on which such proceeds are required to be paid to investors in such securities;

(3) Interest rate or foreign exchange derivatives that:

(i) Materially relate to the terms of such Municipal Securities or contractual rights or assets; and

(ii) Are used for hedging; and

(4) Contractual commitments providing for liquidity protection to such issuer.

Related Definitions:

ABCP means an asset-backed promissory note that has a maturity at the time of issuance not exceeding 397 days, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

ABCP conduit means one or both of the following, as the context requires: an entity that issues ABCP and any special purpose vehicle that (1) uses the proceeds of ABCP issued by an ABCP conduit that is an issuing entity to acquire interests in one or more securitization transactions and (2) is sponsored by the same person that sponsors such issuing ABCP conduit.

Eligible ABCP conduit means an ABCP conduit, provided that:

(1) The ABCP conduit is bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor of the ABCP conduit and from any Intermediate SPV; and

(2) One or more regulated providers have entered into a legally binding commitment to provide, in the aggregate, at least 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or other similar arrangement that may be conditional or unconditional) to all the ABCP issued by the ABCP

conduit by lending to, or purchasing assets from, the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit.

Eligible Assets means assets, other than Loans, which, by their terms, convert to cash within a finite period of time.

Eligible program support provider means one or more regulated provider(s) that (i) is a sponsor of the ABCP conduit for which it provides such support, or (ii) is an affiliate of such sponsor.

Intermediate SPV means a special purpose vehicle that:

(1) Is bankruptcy remote or otherwise isolated for insolvency purposes from each originator-seller of such intermediate SPV; and

(2) Issues, sells, pledges or transfers interests collateralized by such Loans or Eligible Assets to one or more ABCP conduits.

§__.2(q) Loan means (i) any loan, lease (including any lease residual), extension or credit, or secured or unsecured receivables which are acquired, directly or indirectly, by the issuer of asset-backed securities to facilitate the related covered banking entity's client or customer business or financing need, (ii) any note, bond or security collateralized and payable from pools of the items listed in preceding clause (i), and (iii) any contractual rights arising from, or security interests or liens, assets, property guarantees, insurance policies, letters of credit, or supporting obligations underlying or relating to any of the foregoing.

Municipal Securities means municipal securities as such term is defined in Section __.3(b)(9).

Proposed Modification to Section __.16(a)(2):

(2) Notwithstanding paragraph (a)(1) of this section, a covered banking entity may:

(i) Acquire and retain any ownership interest in, or sponsor, a covered fund in accordance with the requirements of this subpart;

(ii) Enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such covered banking entity (or any affiliate or subsidiary thereof) has taken an ownership interest, if:

(A) The covered banking entity is in compliance with each of the limitations set forth in §__.11 with respect to a covered fund organized and offered by such covered banking entity (or an affiliate or subsidiary thereof);

(B) The chief executive officer (or equivalent officer) of the top-tier affiliate of the covered banking entity certifies in writing annually

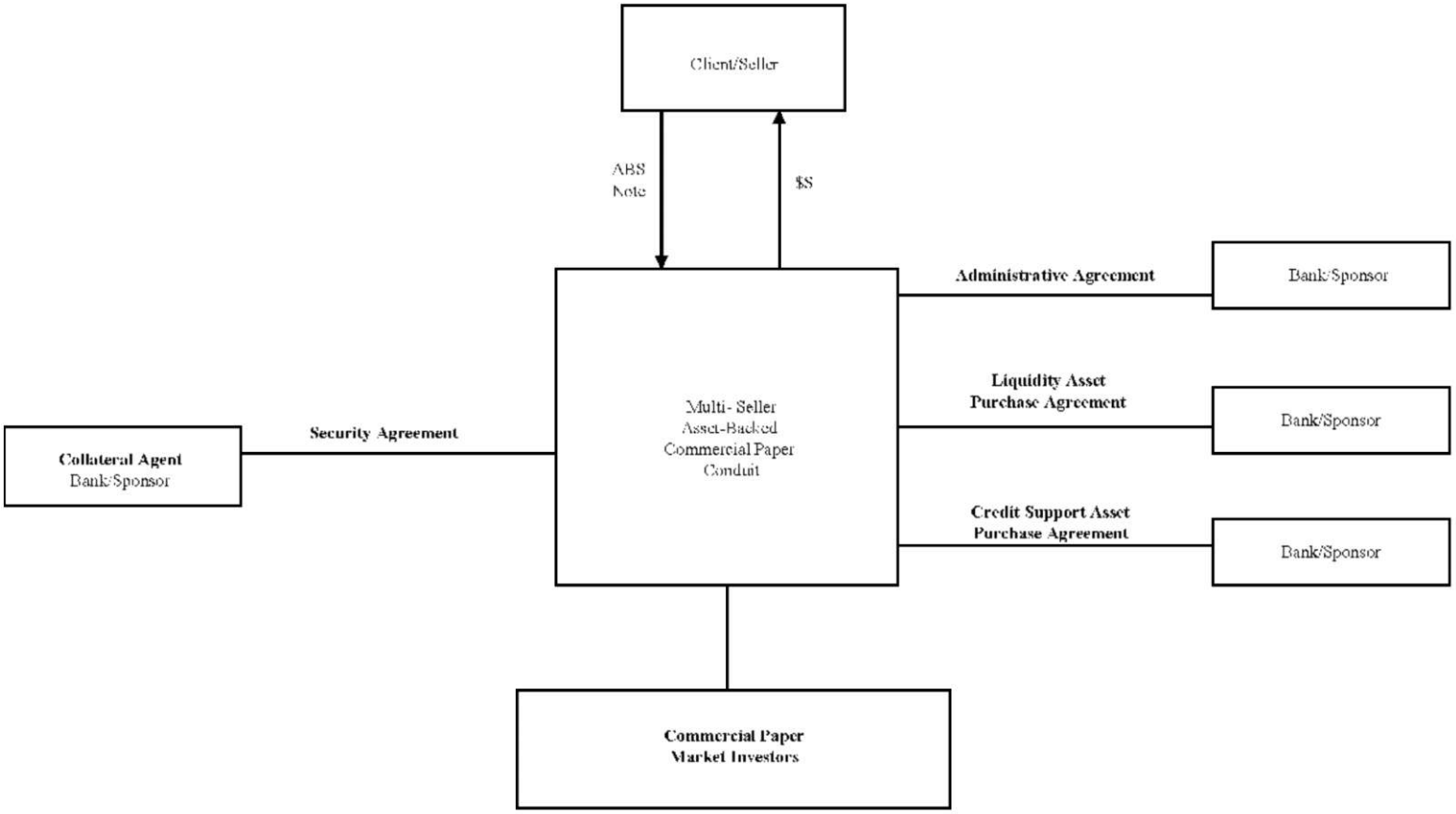
(with a duty to update the certification if the information in the certification materially changes) that the covered banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests,; and

(C) The Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity; and

(iii) Enter into covered transactions with any covered fund in which it acquires or holds an ownership interest or which it sponsors if such covered fund is an issuer of asset-backed securities (including an Eligible ABCP conduit that issues asset-backed securities) in accordance with the limitations set forth in § __.13(d) and § __.14(a); provided that the Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the covered banking entity.

Appendix C-III

Diagrams of Securitization Structures



APPENDIX D

The Agencies should ensure that the Proposed Rule properly accommodates the traditional business of insurance by permitting proprietary trading and "covered fund" investments.

Among its diversified global financial services, RBC offers property, casualty and life insurance services and products in Canada. It also operates a reinsurance business out of Barbados. Congress recognized the importance of making appropriate provisions for the insurance industry, including as one of its articulated purposes that the Legislation should be implemented so as to "appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system."[121] The Proposed Rule contains two exemptions from the Volcker Legislation's prohibitions on proprietary trading that are specific to insurance companies, one relating to the general account of an insurance company (the "General Account Exemption")[122] and one relating to separate accounts of an insurance company (the "Separate Account Exemption").[123]

The General Account Exemption permits a banking entity to purchase or sell a covered financial position if the banking entity is a regulated insurance company acting for its general account or an affiliate of an insurance company acting for the insurance company's general account, subject to the following conditions: (i) the insurance company must directly engage in the business of insurance and be subject to regulation by a state insurance regulator or foreign insurance regulator, (ii) the insurance company or its affiliate must purchase or sell the covered financial position solely for the general account of the insurance company, (iii) the purchase or sale must be in compliance with, and subject to, the insurance company investment laws, regulations and written guidance of the state or foreign jurisdiction in which such insurance company is domiciled, and (iv) the appropriate Federal banking agencies must not have jointly determined that a particular law, regulation or guidance described in item (iii) is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States.

Insurance company exemptions should apply to covered funds investments.

Although the Proposed Rule addresses insurance company exemptions from the Volcker Legislation's prohibitions on proprietary trading in Subpart B, the Proposed Rule is silent on the application of these exemptions to the covered funds investment prohibition in

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[121] BHC Act §13(b)(1)(F).

[122] *See* Proposed Rule, Subpart B, § __.6(c).

[123] *See* Proposed Rule, Subpart B, § __.6(b)(2)(iii).

Subpart C. As the business model for insurance companies includes investment activity both in short-term investments and long-term investments, including hedge funds and private equity funds, we request that the Agencies amend Subpart C of the Proposed Rule to confirm that both the General Account Exemption and Separate Account Exemption apply to investments in covered funds by an insurance company. This interpretation would be consistent with the statutory intent of the Volcker Legislation to accommodate the business of insurance, which should apply equally to the proprietary trading provisions and to the covered funds provisions of the Proposed Rule. In fact, members of the House Financial Services Committee indicated in a joint letter dated, January 27, 2012, that it is "imperative that, as the Agencies move forward, they follow Congressional intent and permit insurance companies to continue investing in covered funds for their general accounts. [They] also request the Agencies confirm, prior to releasing the final rule scheduled in the spring 2012, they will follow this intent . . . . [i]ncluding investments in covered funds within the exemption for insurers would follow the directive included in Section 619 of the Dodd-Frank Act to 'appropriately accommodate the business of insurance.'"[124] We request that the Agencies amend Subpart C of the Proposed Rule to extend the General Account Exemption and Separate Account Exemption to investments in covered funds by an insurance company.

Covered funds are an important part of the investment activity of insurance companies in connection with the asset diversification opportunities that they afford. So long as investments in covered funds are permissible under relevant insurance company investment laws, there is no reason for the Proposed Rule to prohibit investments in covered funds. Congress expressed confidence in the separate insurance regulatory system, including its regulation of the investments of insurance companies, which serves to protect the safety and soundness of insurance companies. In addition, failure to extend the insurance company exemptions to investments in covered funds would cause undue disruption and contravene the recommendations of the FSOC with respect to the implementation of the Volcker Legislation in the area of insurance.

Prohibition on sponsorship of covered funds should not apply to unregistered separate accounts of insurance companies.

We believe that the Agencies should clarify that unregistered separate accounts of insurance companies will not be subject to the Legislation's general prohibition on sponsorship of or investments in covered funds. Although a separate account of an insurance company is not a separate legal entity, and separate accounts historically have not been deemed funds for insurance purposes, it is important to confirm that under the Proposed Rule's definition of "covered fund" that unregistered separate accounts are not covered funds for purposes of the Proposed Rule, as many separate accounts rely on the ICA Fund Exemptions. If unregistered separate accounts were deemed funds for purposes of the Proposed Rule, the question then arises as to whether the applicable insurance company is the fund's sponsor, an activity that is prohibited under the Volcker

[124] Members of Congress Volcker Rule Comment Letter, Jan. 27. 2012.

Legislation. Because unregistered separate accounts are used by insurance companies to facilitate the issuance of many insurance products, including variable life insurance and annuities and corporate-owned life insurance, to resolve any ambiguity, we request that the Agencies confirm that an insurance company is not deemed to sponsor an unregistered separate account within the meaning of the Volcker Legislation. We also ask that the Agencies clarify that separate accounts for which "seed money" has been used qualify for the Separate Account Exemption.

Investment affiliates of insurance companies should not be considered covered funds for purposes of the Volcker Legislation.

Section 619(d)(1)(F) of the Volcker Legislation permits affiliates of regulated insurance companies to purchase, sell, acquire, or dispose of assets as long as such activities are solely for the general account of the regulated insurance company. This provision would be rendered inoperative if the affiliate of the insurance company (*i.e.*, the investment subsidiary formed to invest in authorized investments on behalf of the parent insurance company) were itself considered a covered fund sponsored by the insurance company because such sponsorship is prohibited under the Proposed Rule. We therefore request that the Agencies revise Section __.14(a) of the Proposed Rule to clarify that an affiliate of an insurance company is not a covered fund insofar as it is holding investments for the insurance company's general account, as permitted under relevant state or foreign insurance law.

Insurance companies should be exempt from reporting and recordkeeping requirements of the Volcker Legislation.

The Proposed Rule requires banking entities engaged in any proprietary trading activity or covered fund activity to comply with specified reporting and recordkeeping requirements, as well as such other reporting requirements that the Agencies may impose in the future. In addition, Subpart D of the Proposed Rule requires each banking entity to develop a program designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund investments. Because insurance companies are already subject to comprehensive regulation and surveillance of their permitted investment activities under state and foreign insurance law, we request that insurance companies and their affiliates that engage in proprietary trading or covered fund activities pursuant to Section 619(d)(1)(f) of the Legislation be exempted from the reporting and recordkeeping requirements imposed by the Proposed Rule, including the compliance program requirements of Subpart D.

APPENDIX E

The Agencies should provide greater clarity regarding the statutory conformance period and adopt a more flexible compliance program.

We request that the Federal Reserve clarify the language of Subpart E of the Proposed Rule (the "Conformance Rule") and the guidance in the Notice regarding how covered banking entities will be expected to comply with the Conformance Rule.[125] The Notice describes Subpart E as carrying out the direction of Section 13(c)(6) to "provide a banking entity . . . supervised by the Board a period of time after [July 21, 2012] to bring the activities, investments, and relationships of the banking entity . . . that were commenced, acquired or entered into before [July 21, 2012] into compliance with [Section 13] and the [A]gencies' implementing regulations."[126] The Agencies state in the Notice that the intent of the conformance period after the Legislation's effective date is "to give markets and firms an opportunity to adjust to [Section 13]," citing for authority to a statement of Senator Merkley that, "to give markets and firms an opportunity to adjust, implementation of [the Volcker Legislation] will proceed over a period of several years."[127] Under the Conformance Rule, covered banking entities have a two-year initial conformance period (the "Conformance Period") to bring their activities and investments into compliance with the requirements of Section 13. Upon approval by the Federal Reserve and subject to a number of requirements, a covered banking entity may also receive (i) up to three general one-year Conformance Period extensions, and (ii) one special extension of up to an additional five years for qualifying "illiquid fund" investments.[128]

The Agencies highlight in the Notice that they "expect that a banking entity may need a period of time to prepare for effectiveness of the [P]roposed [R]ule."[129] As previously noted, the Agencies are unlikely to promulgate the final rule more than several weeks, at

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[125] Subpart E of the Proposed Rule is a relocation of the conformance rule previously promulgated in final form by the Federal Reserve on February 9, 2011, pursuant to specific direction in the Legislation at § 13(c)(6). *See* the final rule release titled "Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities," located at 76 Fed. Reg. 8265 (Feb. 14, 2011) (the "Original Conformance Release"). The Notice states that the Conformance Rule includes "certain conforming and technical changes" to the previously promulgated rule as set forth in the Original Conformance Release, and furthermore poses, as Question 347, whether "any portion of the Board's Conformance Rule [should] be revised in light of other elements of the current proposed rule." 76 Fed. Reg. 68,923 (Nov. 7, 2011).

[126] 76 Fed. Reg. at 68,922 (Nov. 7, 2011).

[127] *Id.* at 68,923 (citing to the Original Conformance Release, incorporating its citation to 156 Cong. Rec. S5898 (daily ed. July 15, 2010), the statement by Senator Merkley).

[128] Conformance Rule Section __.31.

[129] 76 Fed. Reg. at 68,855 (Nov. 7, 2011).

most, before the statutorily specified effective date of the Legislation. The affected banking entities will then require a reasonable period of time to review and develop an understanding of the final regime. We are grateful that the Agencies recognize the difficulties that this will pose for covered banking entities in Questions 1-4 in the Notice. However, we submit that the Agencies should craft their guidance regarding the expectations for progress of conformance during the Conformance Period specifically in light of Congressional intent to minimize disruption and harm to affected entities and the practical implications of the absence of final rules for much of the period preceding the Legislation's effective date. Consistent with the core principle behind the Legislation of protecting the integrity and functioning of markets,[130] lawmakers were clear that the conformance periods were provided to prevent harm to markets and to allow affected entities a reasonable opportunity to conform their activities. In this context, Senator Hagan noted that she "was pleased to see that the Volcker [Legislation] will permit banking entities several years to bring their full range of activities into conformance with the new rules," and Senator Merkley cautioned against the risks of market shock.[131] Federal Reserve Board Governor Daniel K. Tarullo also recently noted that the Federal Reserve in connection with seeking to implement the Dodd-Frank Act, "[f]irst and foremost ... want[s] to get it right. This means implementing the statute faithfully, in a manner that maximizes financial stability and other social benefits at the least cost to credit availability and economic growth."[132]

Notwithstanding the foregoing indications that Congress and the Agencies appreciate the need to allow banks to bring their activities within conformance over a period of years, the Agencies state in the Notice that they expect a banking entity to "fully conform all investments to the requirements of the [P]roposed [R]ule as soon as practicable within the conformance periods provided in [Section 13] and [the Conformance Rule]"[133] (emphasis added). This expectation is unsupported by the express language of the Legislation, which requires only that a "banking entity…shall bring its activities and investments into compliance…not later than 2 years after the date on which the requirements become effective," (emphasis added) subject to the potential for the conformance period extensions mentioned above.[134] Moreover, given all the circumstances, including the

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[130] Dodd-Frank Act § 169(d)(1)(I) (The purpose of the act is "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.").

[131] 156 Cong. Rec. S5889, S5899 (daily ed. July 15, 2010).

[132] *Dodd-Frank Act Implementation: Hearing Before the S. Committee on Banking, Housing and Urban Affairs*, 112th Congress (2011) (statement of Daniel K. Tarullo).

[133] 76 Fed. Reg. at 68,855 (Nov. 7, 2011).

[134] BHC Act §13(c)(2). (3) (emphasis added).

expected late issuance of the final rules implementing the Legislation, it is unrealistic to expect that conformance will be "practicable" in the near future.

We also note that the Conformance Rule currently requires that a banking entity's application for any type of conformance period extension must be submitted to the Federal Reserve at least 180 days prior to the expiration of the then-applicable conformance period.[135] Although the Federal Reserve "will seek to act" on such extension requests "no later than 90 calendar days after the receipt of a complete record,"[136] the Federal Reserve traditionally exercises broad discretion in determining when a record for a given application is deemed "complete". Furthermore, the Federal Reserve will likely have a large number of extension applications to evaluate at the same time. The operation of the Conformance Rule means that a covered banking entity may not have extensive advance notice of whether the Federal Reserve agrees with the banking entity's estimation of what constitutes "practicable" conformance (as the banking entity will need to address in the conformance period extension application).[137] We request, therefore, that the Agencies clarify that a banking entity will not be deemed to be in violation of Section 13 or the final rules thereunder so long as its investments and activities are properly conformed as of the expiration of the banking entity's conformance period, as such period may be extended by the Federal Reserve under Section __.31 of the Conformance Rule.

The Federal Reserve proposed in the Notice that a banking entity may not "engage in any new activity or make any new investment in a covered fund without complying with the restrictions and prohibitions of [the Legislation] and implementing rules thereunder."[138] The Federal Reserve further proposed that the original Conformance Release would not (as relocated to Subpart E of the Proposed Rule) "authorize a banking entity to engage in new or additional prohibited activities or investments"[139] (emphasis added). To effect this, the Federal Reserve "expects that each banking entity will identify those trading units of the banking entity that are engaged in prohibited proprietary trading as of or after [July 21, 2012] and the type of proprietary trading in which they are engaged" and that "a trading unit may not expand its activity to include prohibited proprietary trading after [July 21, 2012]."[140]

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[135] Conformance Rule § __.31(c)(1).

[136] Conformance Rule § __.31(e)(1).

[137] *See* Conformance Rule § __.31(d)(1).

[138] 76 Fed. Reg. at 68,923 (Nov. 7, 2011).

[139] *Id.*

[140] Confusingly, this portion of the Notice goes on to state that "[s]imilarly, a trading unit that is not identified as engaging in proprietary trading as of [July 21, 2012] may not begin engaging in such activity

We ask the Agencies to modify their guidance to apply this expectation on an enterprise-wide basis, and to provide, therefore, that trading activity that would be deemed impermissible proprietary trading will be permitted for a banking entity as a whole that was engaged in such proprietary trading before July 21, 2012, as it moves toward bringing its activities into compliance during its applicable conformance period. This would be consistent with the Agencies' general policy that an enterprise should manage its risks on an enterprise-wide basis.[141] If an enterprise is not allowed to address its compliance burden on this basis, it will be forced to expend resources on activities that are not meaningful from a compliance perspective, such as tracking trading information on a trade-by-trade basis, before the date on which compliance with the Legislation is actually required. Our approach would also assist banking entities in bringing their activities into compliance in a manner that will be less disruptive to them and to the markets. For example, a banking entity may determine that the safest and soundest approach to winding down its proprietary trading activities or otherwise bringing its activities into compliance involves a temporary or transitional restructuring of certain activities, such as an organizational combination of certain previously standalone trading functions.

We further submit that, if a form of rebuttable presumption referencing the holding period of a position remains in the definition of "trading account" in the Proposed Rule, the Agencies should make clear that such a presumption will not be triggered by the disposition of a covered financial position by an enterprise in the course of bringing its activities into conformance with the Legislation and the final rules.

We believe that the Agencies should adjust the aggressive implementation timeframes for the Proposed Rule's reporting, recordkeeping and compliance program provisions.

As discussed above, we are deeply concerned with the language in the Notice mandating that, "with respect to the compliance program requirement of the proposed rule, Section __.1 would require a banking entity to have developed and implemented the required program by the proposed effective date [of July 21, 2012]...."[142] Comments to the Proposed Rule must be submitted on or before February 13, 2012. The Agencies, in turn, will be required to analyze the comments, coordinate with the CFTC, which did not approve its version of the Proposed Rule until January 12, 2012, and engage in joint deliberations before adopting final rules. Even if the Agencies do so with alacrity, it will be impossible for covered banking entities to digest the final rule, determine the parameters of a conforming compliance program, complete requisite programming, systems, testing and other changes, and thereafter implement an effective compliance

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after [that date]." *Id.* This would seem to be redundant of the immediately preceding prohibition on a trading unit expanding its activity "to include prohibited proprietary trading."

[141] *See, e.g.*, the Federal Reserve's Supervisory Letter SR 08-8 (Oct. 16, 2008).

[142] 76 Fed. Reg. 68,855 (Nov. 7, 2011).

regime in conformity with the terms of the final rule in the limited time remaining before July 21, 2012. In this regard, we observe that the Volcker Legislation contemplated a nine-month period between adoption of final rules and the scheduled effective date of those rules.

Also, Section __.1 of the Proposed Rule requires a covered banking entity to begin furnishing, "for all trading units or asset management units as of [that] effective date," any reports that may be required under Section __.7 and Appendix A of the Proposed Rule. This is required even though the Agencies note that the "the quantitative measurements furnished for proprietary trading activities that are conducted in reliance on" the Legislation's and the Proposed Rule's conformance period, "would not be used to identify prohibited proprietary trading until such time as the relevant trading activities must be conformed." From a cost-benefit perspective, we seriously question the utility of requiring firms to hastily deploy finite information technology ("IT") resources to build a complex compliance regime for regulations with which they are not yet required to comply. Aside from the impracticality and cost of requiring compliance systems as of the effective date of July 21, 2012, we believe that such reports will almost certainly be deficient, in light of the impossible task of building proper compliance systems by July 21, 2012.

In addition, the reporting and recordkeeping requirements for covered trading activities set forth in Appendix A of the Proposed Rule are extremely broad, requiring firms to capture and analyze massive volumes of data in reviews that, in many cases, are unprecedented in scope and subject matter. Significant time and expense will be required to program IT systems to perform analyses and deliver customized reports of the breadth and complexity proposed. Furthermore, as further discussed below, application of the required programmatic compliance regime on a transactional basis will be unworkable.

The Proposed Rule mandates an unreasonably complex and unduly burdensome compliance program focused on individual transactions.

Pursuant to the Proposed Rule, all banking entities engaged in a covered activity would be required to adopt a compliance program that includes, at a minimum, (i) written policies and procedures, (ii) a system of internal controls, (iii) a management framework that clearly delineates responsibility and accountability for compliance, (iv) independent testing, (v) training and (vi) recordkeeping. Additionally, the compliance program would be charged with identifying "trading accounts" for purposes of differentiating between prohibited and permissible proprietary trading activity (including market making, risk-mitigating hedging and underwriting) in "covered financial positions." As discussed herein, the Proposed Rule broadly defines both trading account and covered financial instruments, requiring the identification of such accounts and covered financial positions across a banking entity's organizational structure, including its affiliates, business divisions, trading units, trading books and possibly to an individual account level basis.

Trade level "intent" and "near-term demands of clients, customers and counterparties" are subjective criteria that are difficult, if not impossible, to demonstrate.[143]

The Proposed Rule requires certain subjective and ambiguous criteria in the compliance framework that would render implementation impracticable. As an initial matter, compliance trade surveillance would be required to identify if the "intent" of any transaction effectuated on a short-term basis was to facilitate permissible trading activity or instead to benefit from prohibited short-term price movements. Additionally, permitted market making related activities may not exceed "reasonably expected near term demands of clients, customers and counterparties" and trading in a financial position that is held for 60 days or less would give rise to the rebuttable presumption that the trade was executed principally for short-term trading purposes.

Firms such as RBC execute tens of thousands of transactions on a daily basis in what would appear to constitute, under the Proposed Rule, covered financial positions in trading accounts. Implementation of a compliance program to establish the "intent" of such transactions to determine whether prohibited trading activity has taken place would be exceedingly burdensome, if not impossible, to administer or enforce. Similarly, in the context of market making activity designed not to exceed the reasonably expected "near-term" demands of clients, customers or counterparties, it is uncertain how a compliance program could delineate the subjective nature of a market maker's discernment of such person's potential demands on a trade-by-trade basis.

Inherently, market making activities for certain businesses, including most fixed income and derivatives products, require retention of positions and assumption of risk for some period of time, which could be days, weeks or even months. Therefore, as previously discussed, resulting "near term" demands of customers (depending on trading unit or product) may require a more robust inventory of financial products to maintain client liquidity. For example, it is unclear what the intended compliance program policy and procedure would be for a situation where a market maker purchases a security from a client to provide necessary liquidity, but for which there is no corresponding readily available buyer for the security.

In both the intent and "near term" contexts, it is unclear what would be considered to be acceptable documentation to rebut a presumption of non-permitted short-term principal trading according to the recordkeeping requirements of the Proposed Rule, and we accordingly request clarification. This is particularly true for permitted market making activities in business lines that commonly maintain inventory for purposes of customer facilitation, as is the case for fixed-income securities.

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[143] *See* Notice Questions 16-17, 23-24, 26-27.

Trade level "intent" and "near term demands of clients, customers and counter parties" are not sufficiently flexible to account for differing "trading account" and asset class product attributes.[144]

Additional ambiguity exists in relation to the Proposed Rule's application of the "intent" requirement to trade level market making activities for each disparate asset class. In this regard, for example, market making activities for an illiquid non-investment grade bond or asset-backed security that goes days or weeks between trades will differ markedly from market making activities for the most actively traded equities, in which thousands of trades occur every hour. The product profile developed by application of inventory metrics (including inventory aging and turnover) and client base will vary by asset class. Attempting to develop automated surveillance programs designed to capture improper "intent" or trading in excess of "near term" demands will inherently lead to massive levels of false positives. Applicability of the inherently subjective "intent" and "near term" standards are also problematic for financial products such as derivatives and foreign exchange forwards which have substantively different market making profiles compared to other financial products. As a result, the Proposed Rule must be modified to make clear that the "intent" and "near term" standards will be applied flexibly. We recommend that both of these standards should constitute non-dispositive factors for consideration under the compliance program.

The Agencies should adopt a more flexible programmatic compliance program that operates at the trading unit level.[145]

We urge the Agencies to avoid applying the programmatic compliance program at the transaction level. We believe that application on a transaction-by-transaction basis is contrary to supervisory objectives of promoting effective risk management and financial stability. Such application will make every commitment of capital subject to potential ex-post review for trading intent, thereby creating a liability dissuading the effective management of risk.

To achieve the desired objectives of the Proposed Rule in an efficient and practical manner, the Agencies should adopt a more flexible programmatic compliance program. Such a program would incorporate the Proposed Rule's requirement that a robust compliance program include written policies and procedures, a system of internal controls, a management framework that clearly delineates responsibility and accountability for compliance, independent testing, training and recordkeeping. However, as an alternative to the Proposed Rule's rigid and unmanageable trade-by-trade approach, the Agencies should consider a risk-based approach at an appropriate business line or activity level, utilizing both quantitative and qualitative metrics to assist in identifying impermissible trading activity. In this regard, the Agencies should permit

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[144] *See* Notice Questions 14, 16-17.

[145] *See* Notice Questions 319, 322-324.

bank entities to continue their risk assessment paradigms, where a "trading unit" is likely to depend on the structure of the individual banking entity, activities and asset classes at issue (*e.g.*, a particular trading unit for purposes of the availability of the market making or risk-mitigating hedging exemption could be a business line or activity level).

We suggest that regulators adopt the proposal put forth in the FSOC Study, which proposes that firms articulate the mission and strategy of permitted trading activities; identify the levels and types of risk required to conduct permitted strategies; and implement a compliance regime of controls to ensure practice complies with policy.

As the Agencies are aware, the FSOC study identified four general categories of risk metrics that banking entities should utilize, namely (i) revenue-based metrics, (ii) revenue-to-risk metrics, (iii) inventory metrics, and (iv) customer-flow metrics. We would support use of these quantitative metrics at a business line or activity level for enforcing compliance policies and procedures. Surveillance, recordkeeping and documentation of the agreed upon quantitative metrics (including corresponding thresholds) would be the basis for demonstrating adequate compliance under the policy provisions.

The foregoing quantitative metrics can be further supported by qualitative metrics, including the Proposed Rule's requirement to consider "near term" customer demands in relation to permitted market-making activities. However, as previously stated, such qualitative measures would only be effective if implemented at a business line or activity level, to take into account how bank entities actually manage related risks. Further, such qualitative measures should not be dispositive of whether the trading activity is classified as permitted or non-permitted, but rather should be considered as part of an overall assessment that includes consideration of quantitative metrics. This would allow banking entities the ability to consider, for example, the manner in which market marking is facilitated based upon unique product characteristics, client profile and other market making factors that vary from product to product, and trading unit to trading unit.

Consideration of such non-exclusive quantitative and qualitative market marking factors would better tie the compliance program to the overall objectives of the Volcker Legislation, as opposed to narrowly focusing on "intent" or metrics such as a financial product's price appreciation, which may not be indicative of whether certain trading activity is permissible. Such a flexible approach would also facilitate the ability of banking entities to engage in other important and permitted market making functions, including intermediation activity with counterparties and trading inventory management to facilitate customer demand.

Certain quantitative risk metrics required by the proposed rule are not currently available or may not achieve the intent of the Volcker Legislation.[146]

As noted above, banking entities will be expected to rely heavily on four primary categories of quantitative metrics: general risk metrics, revenue metrics, revenue to risk metrics, and customer facing metrics (including inventory metrics). While we agree that quantitative metrics should be elements of an effective compliance program, considerable dialogue with the respective Agencies should take place during the Conformance Period to ascertain which metrics provide the most utility. Although certain well-established risk management metrics are widely utilized and may be readily available for Agency reporting, other metrics identified by the Proposed Rule are not in general use by banks in risk management and may require considerable infrastructure development or entirely new methods of data capture which are not currently available. Others do not appear to be useful in accommodating the flexible compliance approach we recommend. Specifically, we believe that the Spread Profit and Loss, VaR Exceedance, Comprehensive Profit and Loss Attribution and Pay-to-Receive Spread Ratio metrics should be eliminated because they would not be useful, are difficult to compute and do not yield helpful data. Before requiring development of such new (and untested) metrics, the Agencies should evaluate the utility of metrics that already exist or that can be readily adapted from current risk management tools.

The Agencies should adopt a tiered programmatic compliance program rather than a trade-by-trade approach.[147]

We proposed that the Agencies institute a tiered programmatic compliance program in lieu of a trade-by-trade approach. The tiered compliance program would utilize various controls during the life-cycle of a transaction, including on a pre-execution, execution and post-execution basis. The first tier of the compliance program would establish written policies and procedures to govern authorized trading activities in approved products. It would include pre-established trading unit policies or business line mandates that describe and delineate responsibility and accountability for allowable activity. Additionally, pre-established quantitative risk metrics would be assigned to the associated trading units, such as business lines or activity levels, tailored to the specific products and businesses for maximum effectiveness. The specific metrics as applied could be developed over time through effective collaboration with applicable Agencies during the Conformance Period.

The second tier of the programmatic compliance program would focus on a system of internal controls for monitoring compliance with assigned quantitative risk metrics for trading activities. Compliance surveillance would be implemented for the applicable trading units or business lines to monitor adherence with any pre-established

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[146] *See* Notice Questions 167-171, 187-188.

[147] *See* Notice Questions 319-320 and 322-323.

requirements. A final tier of the compliance framework would focus on post-execution review and independent testing. This would include surveillance review and exception reporting, issue escalation, supervisory controls, record keeping and independent testing. Training would also be performed for the control functions responsible for monitoring, reviewing, and testing compliance. Finally, the third tier of post-execution quantitative metric reviews may also be performed at periodic intervals to monitor the effectiveness of established metrics over longer time horizons.

The programmatic compliance framework should be simplified and adapted to account for existing risk-mitigating metrics.

Implementation of a comprehensive programmatic compliance framework for the Proposed Rule will be a significant challenge due to its broad scope and complexity. Given the importance of allowing banking entities to continue providing customer liquidity, financial intermediation, and effective risk-mitigating hedging activities, the Proposed Rule should be simplified. Banking entities should be given the opportunity, wherever possible, to utilize existing risk metrics currently in use by risk control functions. This would alleviate additional costs and complexity in establishing, analyzing, and testing the newly-proposed metrics required by the Proposed Rule, including metrics associated with certain revenue relative to risk and customer-facing metrics that are not currently widely utilized.

Specifically, requirements for substantiating trade-level permitted activities should be eliminated or greatly reduced in scope. As an alternative, greater flexibility should be provided in establishing a compliance program that is properly tailored to achieving objectives of the Legislation. Such modification will provide the necessary certainty in establishing an effective and comprehensive programmatic compliance framework, while concurrently ameliorating the need for significant investment in complex infrastructure and resource allocation. Instead, firms should be permitted flexibility in establishing applicable trading desk and/or business level mandates that affirmatively articulate the objective of the business so as to establish permitted business activity.

Furthermore, significant investments necessary to meet the programmatic compliance regime requirements envisioned by the Volcker Legislation can be attributed to the inherent ambiguity and subjectivity associated with justifying "permitted" activities pursuant to the requirements of the Proposed Rule. As already discussed above in Appendix A, the Proposed Rule's exemptions present a number of ambiguities that would make it difficult for traders to distinguish between impermissible proprietary trading and beneficial activities that fall within the various exemptions. Attempting to monitor and distinguish permissible trading activity from non-permitted activity described as proprietary trading will only lead to greater marketplace confusion.

As currently proposed, the Proposed Rule appears to require significant development and investment in IT system infrastructure, new surveillance monitoring and reporting, new proposed risk metrics and associated supporting systems, global policies and procedures and a comprehensive means to maintain adequate books and records for substantiating

permitted trading activity related to market-making, risk-mitigating hedging and underwriting activities. These requirements must be implemented both domestically for covered asset classes and trading areas, as well as, cross-jurisdictionally for affiliated entities with a U.S. nexus. This appears to be true, even where the nexus of such trading activity on behalf of U.S. clients is limited to interaction with the foreign entity's U.S. affiliate in sovereign bonds. Additionally, significant investment in human resources will be required to maintain the ongoing supervision, analysis and independent testing necessary to provide senior management adequate comfort in substantiating the effectiveness of the compliance control program. Given the scope and magnitude of the Proposed Rule's requirements, we believe that related modifications are necessary in order to provide clarity and simplicity, particularly for the requirements associated with permitted activities, and sufficient flexibility in terms of banking entities' properly tailored compliance programs.

The programmatic compliance program should not be imposed on foreign banking activities that do not implicate risk-taking within the United States.

As currently drafted, the Proposed Rule is ambiguous as to whether and how the programmatic compliance requirements will be applied to foreign banking activities that do not implicate risk-taking within the United States. We submit that the compliance requirements should not apply extraterritorially, particularly if it would not further the objectives of the Volcker Legislation. The indiscriminant application of the programmatic compliance requirements abroad would constitute an expansion of U.S. regulatory reach into the home countries of international banks, with no added benefits to U.S. financial stability. Oversight or examination by the Agencies of trading occurring outside of the U.S. in non-U.S. affiliates of foreign banking organizations, in particular, would appear to raise sensitive issues of jurisdiction and sovereignty, and could place banks in untenable positions of conflict (e.g., where the Agencies demand production of trade data, or identification of counterparties, where home country or other non-U.S. regulatory authorities require confidentiality or anonymity). Therefore, we ask that the Agencies clarify that only banking entities engaging in proprietary trading or the investment in or sponsorship of funds in the United States would be subject to the programmatic compliance regime.