HSBC

**Stuart Alderoty**
Senior Executive Vice President and General Counsel

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

Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20551

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

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

February 13, 2012

**Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Proposed Rule; 76 Federal Register 68846; November 7, 2011; Joint Notice and Request for Comment; OCC:** Docket ID OCC-2011-14; **FRB:** Docket No. R-1432 and RIN 7100 AD 82; **FDIC:** RIN 3064-AD85; **SEC:** File Number S7-41-11; **CFTC:** RIN 3038-AD05

Ladies and Gentlemen:

HSBC Bank USA, National Association ("**HBUS**") and its global affiliates (collectively, "**HSBC**") appreciate the opportunity to submit comments regarding the proposed rule (the "**Proposed Rule**")[1] on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds jointly issued by the Office of the Comptroller of the Currency (the "**OCC**"), Board of Governors of the Federal Reserve System (the "**Board**"), Federal Deposit Insurance Corporation (the "**FDIC**") and Securities and Exchange Commission (the "**SEC**") and subsequently re-proposed by the Commodity Futures Trading Commission (the "**CFTC**," and, together with the OCC, the Board, the FDIC and the SEC, the "**Agencies**"). The Proposed Rule would implement Section 619 ("**Section 619**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), commonly known as the "Volcker Rule".[2]

---

1 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011) (to be codified at 12 C.F.R. pts. 44, 248 & 351, 17 C.F.R. pt. 255).

2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716, 124 Stat. 1376, 1620 (July 16, 2010).

**HSBC North America Holdings Inc.**
452 Fifth Avenue, 10th Floor, New York, NY 10018
Tel: (212) 525-8877 Fax: (212) 525-8447
stuart.a.alderoty@us.hsbc.com

We support the efforts of the Agencies to promote safety and soundness throughout the financial system consistent with the guiding principles of the Dodd-Frank Act. However, we believe that the Proposed Rule should be more closely aligned with the Congressional intent of the Volcker Rule. To this end, this comment letter seeks to complement and amplify the arguments outlined in comment letters submitted by Allen & Overy LLP on behalf of foreign banks, including (a) the comment letter on covered funds and securitizations, (b) the comment letter on non-U.S. government debt obligations and (c) the comment letter on non-U.S. swap activities.[3] HSBC also endorses the submissions of the Institute of International Bankers ("**IIB**")[4] and the Securities Industry and Financial Markets Association ("**SIFMA**")[5] (collectively, the "**Additional Comment Letters**"), which express concern about the implications and unintended consequences of the broad extraterritorial reach of the Proposed Rule. Consistent with the Additional Comment Letters and other letters sent to the Agencies by foreign banking regulators,[6] we respectfully request that the Agencies re-propose the rulemaking to limit the extraterritorial application of the Proposed Rule.

## 1. EXECUTIVE SUMMARY

The Proposed Rule, contrary to legislative intent, would result in expansive extraterritorial application of the Volcker Rule's proprietary trading and covered fund restrictions. We urge the Agencies to reconsider the extraterritorial reach of the Proposed Rule by making the following changes:

- Expanding the "solely outside the United States" ("**SOTUS**") exemption so that proprietary trading activities of non-U.S. banks that do not result in additional risk being added to the U.S. financial system fall outside the scope of the Volcker Rule.

---

3 Allen & Overy LLP, to Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n (to be filed with Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n) [hereinafter "A&O Covered Funds Letter"].; Allen & Overy LLP, to Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n (to be filed with Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n) [hereinafter "A&O Non-U.S. Government Debt Letter"]; Allen & Overy LLP, to Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n (to be filed with Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n) [hereinafter "A&O Title VII Letter"].

4 Sarah A. Miller, Chief Exec. Officer, Inst. of Int'l Bankers, to Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n (to be filed with Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Dep't of the Treasury, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n) [hereinafter "**IIB Letter**"].

5 Securities Industry and Financial Markets Association, to Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Dep't of the Treasury, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n (to be filed with Bd. of Governors of the Fed. Reserve Sys., Commodity Futures Trading Comm'n, Dep't of the Treasury, Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, & Sec. & Exch. Comm'n) [hereinafter "**SIFMA Letter**"].

6 *See e.g.*, Letter from Julie Dickson, Superintendent, Fin. Insts. Can., to Office of the Comptroller of the Currency, Commodity Futures Trading Comm'n, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Sec. & Exch. Comm'n (Dec. 28, 2011) (on file with Office of the Comptroller of the Currency, Commodity Futures Trading Comm'n,, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Sec. & Exch. Comm'n) [hereinafter "**OSFI Letter**"]; Letter from Gadi Mayman, Chief Executive Officer, Ontario Financing Authority, to Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Sec. & Exch. Comm'n (Jan. 31, 2012) (on file with Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Sec. & Exch. Comm'n) [hereinafter "**OFA 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.) [hereinafter "**HM Treasury Letter**"]; Letter from Masamichi Kono, Vice Commissioner for International Affairs, Financial Services Agency, Government of Japan, and Kenzo Yamamoto, Executive Director, Bank of Japan, to Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Sec. & Exch. Comm'n (Dec. 28, 2011) (on file with Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Sec. & Exch. Comm'n) [hereinafter "**Japanese Letter**"].

- Extending the exemption for proprietary trading in U.S. government obligations to cover non-U.S. government obligations, state and municipal agency obligations and derivatives on each of these categories of securities.

- Broadening the scope of the Proposed Rule's exemptions for market making, risk-mitigating hedging, customer facilitation and other permitted activities.

Finally, the conformance period for Volcker Rule compliance should be tailored to provide sufficient time for complex banking entities to put in place the necessary monitoring and reporting infrastructure and the Agencies should conduct a more rigorous cost-benefit analysis of the Proposed Rule, attentive to the comments below and consistent with the principles laid out in the recent Business Roundtable case.[7]

## 2. THE STRUCTURE OF HSBC GROUP

As an international financial services company, HSBC provides financial services to a broad spectrum of clients in over 80 countries. HSBC is structured as a global holding company with separate legal operating subsidiaries throughout the world, each of which is subject to local regulation. The global HSBC network includes, among other entities, HSBC Bank plc in the United Kingdom, HSBC France in France, The Hongkong and Shanghai Banking Corporation Limited in Hong Kong, HSBC Bank Canada in Canada, and, with over $200 billion in banking assets in the United States, HBUS.[8] HSBC also has a significant local presence in many other jurisdictions that supports the growth and development of various emerging markets such as through HSBC Mexico S.A. and HSBC Bank Brasil S.A. in Latin America and HSBC Bank Middle East Limited in the Middle East. HSBC operates outside of the United States through locally capitalized entities, which do not guarantee the obligations of HBUS or any insured depository institution and are not guaranteed by HBUS or any U.S. insured depository institution. Additionally, HSBC's non-U.S. entities are generally not subject to U.S. regulation in connection with their non-U.S. banking activities, consistent with longstanding U.S. banking precedent.[9]

### 2.1 The Extraterritorial Application of the Proposed Rule Should Be Limited

#### (a) The Broad Definition of "Banking Entity" Should Not Apply to the Non-U.S. Banking Activities of International Financial Institutions[10]

The Proposed Rule fails to follow legislative intent by combining the broad definition of "banking entity" in Section 619 of the Dodd-Frank Act with a narrow series of limited exemptions. This approach means that the entire HSBC global network of separate local affiliates could be subject to the Volcker Rule's restrictions.

---

7 *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011). For further discussion of this case and cost-benefit analysis generally, see the SIFMA Letter, *supra* note 5.

8 *Structure Data for the U.S. Offices of Foreign Banking Organizations*, FED. RESERVE BD., http://www.federalreserve.gov/releases/iba/201109/bycntry.htm (Dec. 15, 2011).

9 The Bank Holding Company Act [hereinafter "**BHC Act**"] generally prohibits a U.S. bank from engaging in activities that are not "so closely related to banking as to be a proper incident thereto." *See* 12 U.S.C. § 1843(a), 1843(c)(8). The potential extraterritorial impact of these activities restrictions, however, is limited in part by exemptions for "qualifying foreign banking organizations" [hereinafter "**QFBO**"], which are permitted to engage in any activity outside the United States and in certain activities in the United States, which are more varied than those permitted to domestic bank holding companies. The qualifying foreign banking organization concept is found in Subpart B of the Board's Regulation K, 12 C.F.R. pt. 211, which implements in part the statutory exemptions from the BHC Act's coverage set forth in Sections 2(h)(2) and 4(c)(9) of the BHC Act. HSBC Holdings plc is registered as a QFBO.

10 This section serves to respond to Questions 5 and 6 posed by the Agencies in the Proposed Rule.

The Volcker Rule defines a "banking entity" as: "(1) Any insured depository institution; (2) Any company that controls an insured depository institution; (3) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and (4) Any affiliate or subsidiary of any entity described in paragraphs [(e)](1), (2), or (3) of this section [...]."[11] Read in isolation and without regard for the exemptions embedded within the statute, the last prong of this definition would extend the prohibitions in the Volcker Rule to all activities, including many non-U.S. activities, of non-U.S. affiliates of a U.S. bank such as HBUS. Such an approach would result in trading and investment prohibitions, extensive and duplicative compliance requirements and reporting obligations for non-U.S. entities and would pose significant restrictions on the ability of HSBC to meet the financial needs of its customers around the world. To impose the Volcker Rule's restrictions in this manner on non-U.S. affiliates of a U.S. bank would be inconsistent with current and historical cross-border bank supervision, which as a broad matter of policy seeks to promote international comity and regulatory cooperation while reducing duplicative or overlapping regulatory requirements.

Congress intended that the Volcker Rule would adhere to existing U.S. banking precedents and interpretative guidance, including established principles of comity and deference to applicable foreign law. Senator Merkley, a principal author and sponsor of the Volcker Rule, explained that the statutory exceptions for activities conducted "solely outside the United States" were designed to "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] Senator Hagan expressed her understanding in the Congressional Record that the SOTUS funds exceptions would be implemented according to the Board's existing precedents and practices under sections 4(c)(9) and 4(c)(13).[13]

We therefore urge the Agencies to reduce significantly the broad extraterritorial interpretation set forth in the Proposed Rule. This reduction can be accomplished by ensuring that the statutory exemptions discussed below are properly reflected in the Proposed Rule so that proprietary trading and covered funds activities that are not conducted within the United States fall outside the scope of the Volcker Rule.

(b) The Exemption for Trading Activity Occurring "Solely Outside the United States" Should be Expanded[14]

Among the stated goals of the Volcker Rule is the desire to control U.S. systemic risk by restricting proprietary trading conducted by banking entities within the United States.[15] Consistent with this goal, Congress

---

11 *Dodd-Frank Act*, supra at 2, § 619(h)(1).

12 156 Cong. Rec. S5870, S5897 (daily ed. July 15, 2010) (statement of Sen. Jeff Merkley).

13 *See id.* at S5889-S5890 (statement of Sen. Kay Hagan) ("For consistency's sake, I would expect that, apart from the U.S. marketing restrictions, [the SOTUS funds exceptions] will be applied by the regulators in conformity with and incorporating the Federal Reserve's current precedents, rulings, positions, and practices under sections 4(c)(9) and 4(c)(13) of the BHC Act so as to provide greater certainty and utilize the established legal framework for funds operated by bank holding companies outside of the United States.")

14 This section of our letter seeks to address Question 136 of the Proposed Rule.

15 The statutory mandate for the Financial Stability Oversight Council ("**FSOC**") study as well as the study itself emphasized these underlying purposes of the Proposed Rule. *See* BHC Act §§ 13(b)(1)(B) and (C) (instructing the FSOC to conduct a study on how to implement the Proposed Rule so as to, among other things, protect taxpayers and limit the transfer of federal subsidies from banks to their unregulated affiliates); Fin. Stability Oversight Council, U.S. Dept' of the Treasury, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds 1 (2011), *available at* http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf ("The Volcker Rule prohibits banking entities, which benefit from federal insurance on customer deposits or access to the discount window, from engaging in proprietary trading and [covered fund activities], subject to certain exceptions.") (emphases added). *See also* id. at 9 (proposed framework intended to "limit the transfer of subsidies from the federal support provided to depository institutions to speculative activities"); id. at 15-16 ("Congress intended to strictly restrain speculative risk taking in the form of proprietary trading by banking entities, which benefit from the

acknowledged that extraterritorial application of the Volcker Rule should be limited to exclude proprietary trading activities conducted SOTUS by non-U.S. entities with an emphasis on the location of risk.[16] As the statutorily mandated "Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds" undertaken by the Financial Stability Oversight Council (the "**FSOC Study**") notes, the "Volcker Rule applies to domestic banking operations of foreign institutions. However, because of U.S. extra-territorial regulatory constraints, the statute does not restrict proprietary trading conducted by non-U.S. entities outside the United States."[17]

The SOTUS framework in the Proposed Rule would regulate activities that do not result in additional risk being added to the U.S. financial system; instead, any activity that even tangentially touches the financial infrastructure of the United States (e.g., through use of U.S. execution facilities) would be regulated by the United States. As such the Volcker Rule would apply not only to transactions with a U.S. counterparty, but also to transactions that have limited connections to the United States, including any transaction where the securities relevant to the transaction are traded on a U.S. exchange.[18] Regulating transactions that feature these tangential connections to the United States is inconsistent with the intent of the SOTUS exemption, does not bolster U.S. financial stability and unnecessarily limits the ability of non-U.S. entities to trade in U.S. financial markets.

To use a practical example for emphasis, the SOTUS exemption as currently drafted under the Proposed Rule would limit the ability of our Hong Kong affiliate, which is independently capitalized, to purchase for its own account securities traded on a U.S. exchange, or trade for its own account utilizing a U.S. agent to effect a transaction. Further, even if these transactions were conducted for a "permitted" purpose (e.g., market making or risk-mitigating hedging), the non-U.S. affiliate would be subject to extensive U.S. compliance requirements. If similarly situated entities become subject to regulation under the Proposed Rule or are forced to withdraw from U.S. financial markets, we believe the result will be an inevitable limitation in trading options available to clients, including both customers and governments and the potential for significant reduction in liquidity for an array of products currently offered in financial markets both here in the United States and internationally. Removing the ability of non-U.S. affiliates to act as market participants, even outside of the United States, will result in decreased competition and, as a result, less favorable pricing and liquidity for customers and end-users.

A narrow SOTUS exemption could result in market access disruption for U.S. customers. By way of another example, U.S. customers frequently seek access to financial instruments available in local markets of HBUS's independently-capitalized affiliates in Latin America. Trades are executed directly between the non-U.S. affiliate and the U.S. customer and risk resides on the non-U.S. affiliate balance sheet. To further this example, it is common market practice for a U.S.-based sales force, fully subject to existing U.S. law and regulation applicable to persons conducting sales activities in the U.S., to act as a distribution point for the local market products to U.S. customers. In this case, the Proposed Rule would apply to the Latin American entity as it is transacting with a U.S. person and utilizing U.S. sales personnel, despite the fact that risk resides outside the U.S. As such, proprietary trading restrictions would apply to these activities unless some permitted purpose (as discussed below)[19] can be found. Further, although trading on behalf of a customer may be permitted under the

---

support of federal deposit insurance and access to discount window borrowing" and "permitted activities are limited to important forms of financial intermediation that Congress concluded are permissible in the context of entities that have the support of federal deposit insurance and discount window access").

16 *See* BHC Act § 13(d)(1)(H), *as amended by* Dodd-Frank Act, *supra* note 2, § 619, at 1626 (to be codified at 12 U.S.C. 1851(d)(1)(H)).

17 *See* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 15.

18 Proposed Rule §_.6(d).

19 See Section 3 of this letter, *infra*.

Proposed Rule, given the relatively illiquid nature of certain markets, HSBC's affiliate may be required to take market risk in the underlying instrument for extended periods in order to offer such products to clients as part of an ongoing business. This would lead to these typical trading activities, and numerous others, being prohibited under the Proposed Rule and would lead to severe disruptions in access to the Latin American and other non-U.S. financial markets for U.S. customers.

We view these outcomes as beyond the scope of the Congressional intent of the Volcker Rule, and we respectfully request that the Proposed Rule be modified so that the SOTUS exemption would relate solely to the location of the resultant risk.

(c) Trading in Securities of Non-U.S. Governments[20]

Section 619(d)(1)(A) of the Dodd-Frank Act and Section __.6(a) of the Proposed Rule create an exemption from the ban on proprietary trading for U.S. government obligations that includes trading in U.S. federal, state, municipal, general, limited, and pass-through obligations and forward trading.[21] In creating such an exemption from the ban on proprietary trading, the Volcker Rule and the Proposed Rule implicitly acknowledge that (i) the proprietary trading ban will reduce trading, and therefore liquidity, in respect of any obligations to which it applies, and (ii) issuers of any debt in a form that is subject to such proprietary trading ban will likely face at least some additional difficulty in obtaining financing.[22]

As currently drafted, this exemption does not extend to non-U.S. government obligations. Restricting the ability of banking entities to participate in markets for non-U.S. sovereign debt will have a dramatic and deleterious effect on the liquidity, and therefore the price, of those obligations to all market participants including both our customers and the sovereigns issuing such obligations. The decreased liquidity of these instruments would undermine the safety and soundness of both the U.S. and non-U.S. banks that trade in these securities. To the extent liquidity is reduced in obligations that a bank is obligated to trade in, either based on client demand or pursuant to primary dealer regulations, the bank's financial health may be jeopardized. Further, limiting the exemption to trading in U.S. government obligations only would subject banks to increased concentration risk. As evidenced in the last financial crisis, impairing the health of any sector of the financial system reduces available credit, and increases contagion risk to other financial institutions within the system.

---

20 This section of our letter is intended to address, among others, Question 122 of the Proposed Rule, in which the Agencies ask whether an additional exemption should be adopted for proprietary trading in the obligations of foreign governments. *See* 76 *Fed. Reg.* at 68878, Question 122 ("Should the Agencies adopt an additional exemption for proprietary trading in the obligations of foreign governments and/or international and multinational development banks under Section 13(d)(1)(J) of the BHC Act? If so, what types of obligations should be exempt? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?").

21 Section __.6(a) of the Proposed Rule implements Section 619(d)(1)(A) and provides that "(1) The prohibition on proprietary trading contained in §1.3(a) does not apply to the purchase or sale by a covered banking entity of a covered financial position that is: (i) An obligation of the United States or any agency thereof; (ii) An obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.); or (iii) An obligation of any State or any political subdivision thereof. (2) An obligation or other instrument described in paragraphs (a)(1)(i), (ii) or (iii) of this Section shall include both general obligations and limited obligations, such as revenue bonds."

22 Additionally, this exemption recognizes that a ban on proprietary trading in U.S. government obligations would affect the ability of the federal reserve banks to implement monetary policy. The Federal Reserve Bank of New York (the "New York Fed"), for example, trades U.S. government and select securities with designated primary dealers, including large commercial banks and investment banks. The existence of the exemption allows these entities to continue entering into proprietary trades with the New York Fed, and such trading assists the New York Fed in implementing monetary policy.

We join the governments of Canada,[23] Japan[24] and the United Kingdom[25] in urging the Agencies to use their exemptive power under Section 619(d)(1)(J) to create a new exemption for non-U.S. government obligations. The rationale underpinning the U.S. government obligations exemption also applies to the creation of an exemption for non-U.S. government obligations. We submit to the Agencies that the creation of this new exemption is consistent with promoting the safety and soundness of the banking system and the financial stability of the United States. In the alternative, we respectfully request that the Agencies defer to home country regulators and allow non-U.S. banking entities to engage in proprietary trading in any government obligation to the extent that such trading is permitted by the entity's primary prudential regulator.

In response to Question 121 posed by the Agencies in the Proposed Rule, we believe that trading in derivatives on government obligations should be included as a permitted activity. Not including such trading, and therefore limiting the permitted activity to only the underlying cash instruments, would significantly restrict the activity explicitly permitted by Congress and decrease liquidity in these government obligations and would distort the market in these instruments, which currently utilizes derivatives extensively.

Finally, as discussed more fully in the Additional Comment Letters, we believe that the permitted activity should not be limited to state and municipal government bonds, but should also include state and municipal agency obligations.[26]

## 3. THE MARKET-MAKING AND HEDGING EXEMPTIONS SHOULD BE EXPANDED

While the Proposed Rule defines "proprietary trading" broadly, it narrowly defines the scope of market making, risk-hedging, customer facilitation and other permitted activities. The stringent criteria for these exemptions under the Proposed Rule could prohibit many recognized trading practices associated with these permitted activities and could be potentially detrimental to the global capital markets.

For example, the Proposed Rule lists factors that are difficult to predict or account for at the outset of a trade and could result in HBUS, or any one of over 80 HSBC global affiliates who cannot meet the proposed SOTUS exemption, inadvertently engaging in prohibited trading activity in the normal course of business (e.g., as a liquidity provider).[27] As described in the Additional Comment Letters, we believe that the Agencies should replace the proposed criteria-based approach with an approach that permits entities to satisfy customer liquidity needs in compliance with reasonably-designed policies and procedures, good-faith compliance with which should serve as a safe harbor from breach of the Volcker Rule.[28] The criteria in the Proposed Rule should be removed from the rule itself and be treated as interpretive guidance to be used in designing such policies and procedures.

We further agree with the recommendations of the Additional Comment Letters that, among other recommendations, the Agencies should not analyze the market making-related permitted activity on a

---

23 OSFI Letter, *supra* note 6; OFA Letter, *supra* note 6.

24 Japanese Letter, *supra* note 6.

25 HM Treasury Letter, *supra* note 6.

26 *See e.g.*, SIFMA Letter, *supra* note 5.

27 Taking market risk is necessary to, and inseparable from, market-making and other essential trading activities such as price discovery and providing liquidity and customized services to customers. To be required to consider how long certain market risk can be taken before a position is considered proprietary would significantly alter trading strategies and business models, which will limit the ability of banking entities to provide liquidity and more favorable pricing to customers.

28 *See e.g.*, SIFMA Letter, *supra* note 5.

transaction-by-transaction basis, and the regulations implementing the market making-related permitted activity should reflect varying roles of market-makers acting as intermediaries between different types of market participants in different physical locations, at different times and in different size.[29]

In addition, it is impossible to define the concept of "risk-mitigating hedging" with certainty. We are encouraged that the Agencies recognize the practice of a "portfolio" approach to hedging, but note that various trading activities have different characteristics and require different risk-management techniques, and it is therefore not possible to capture all varieties of risk-mitigating hedging within the Proposed Rule. As noted in the FSOC Study, the application of the risk-mitigating hedging exemption, among others, in different markets will require various adjustments by the Agencies because "the relevance or utility of any particular metric may vary significantly depending on the asset class, liquidity, trading strategy and market profile of the trading activity in question."[30] Therefore, we would support a more principles-based approach to defining permissible risk mitigation, which would require a banking entity to document risk-mitigating hedging strategies for submission to its regulator. These documented strategies, together with any applicable thresholds, would then be used by the regulators to monitor or ensure that the banking entity is conducting a permitted activity.

Further, if permissible hedging activities are strictly categorized, it will be inefficient, and possibly ineffective, for a trading desk to attempt to hedge its risk utilizing prescribed methodologies which may not be broad enough to cover the trading at hand. This hedging limitation would then restrict a trading desk's ability to efficiently offer a broad range of financial products to customers for their own investment purposes.

The comments made in this section seek to complement and further the points outlined in industry studies[31] and comment letters.[32]

## 4. ENSURING A SUFFICIENT TIMEFRAME FOR COMPLIANCE[33]

Under the Proposed Rule, the initial compliance date by which banking entities must have a compliance reporting infrastructure in place is July 21, 2012. Unfortunately, the scale and size of modern global financial institutions make the design and implementation of such a complex infrastructure impossible in the proposed timeframe. Additionally, there remains a high number of questions and an unusually high level of uncertainty concerning the Proposed Rule and how the Agencies will choose to revise the rule over the next few months. The current regulatory uncertainty undermines any attempts to make even a preliminary determination as to the scope of the compliance infrastructure required by the Proposed Rule.

Further, under the Proposed Rule, banking entities must "fully conform all investments and activities to the requirements of the proposed rule as soon as practicable within the conformance periods...."[34] We respectfully request that the Agencies clarify the period of time that a banking entity has to comply with the regulations. The Agencies should further confirm that the time period for conformity should be linked to the date of the release of

---

29 *Id.*

30 FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 15, at 37

31 *See, e.g.*, OLIVER WYMAN, INC. & SEC. INDUS. AND FIN. MKTS. ASS'N. THE VOLCKER RULE: CONSIDERATIONS FOR IMPLEMENTATION OF PROPRIETARY TRADING REGULATIONS (2011), *available at* http://www.sifma.org/issues/item.aspx?id=22888.

32 *See, e.g.*, Darrell Duffie, Dean Witter Distinguished Professor of Finance, Graduate School of Business, Stanford University, to Dep't of the Treasury, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Sec. & Exch. Comm'n (Jan. 16, 2012) (on file with Dep't of the Treasury, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Sec. & Exch. Comm'n)

33 This section seeks to address Questions 1, 2 and 3 of the Proposed Rule.

34 Proposed Rule, *supra* note 1, at 68855.

any final rule, as opposed to a fixed date, and that the maximum amount of time permitted by the statute should be granted to financial institutions of the size and complexity of HSBC. In particular, the Agencies should clarify what requirements will apply to both domestic and international activities. If different compliance metrics are applicable to international financial institutions, a sample set of metrics and compliance guidance should be provided.

* * *

We would be pleased to provide further information or assistance at the request of the Agencies or their staffs. If you should have any questions with regard to the foregoing, please do not hesitate to contact Suzy White, Chief Operating Officer, HSBC Global Markets (Americas), at (212) 525-3230 or Mark Steffensen, General Counsel, HSBC Global Banking & Markets (Americas), at (212) 525-8119.

Very truly yours,

Stuart Alderoty
Senior Executive Vice President and
General Counsel