



**BANK OF CANADA
BANQUE DU CANADA**

Mark Carney
Governor – Gouverneur

13 February 2012

Dr. Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

**Re: Joint Notice of Proposed Rulemaking Implementing the Volcker Rule:
Federal Reserve Docket No. R-1432 and RIN-7100 AD 82; OCC Docket
ID OCC-2011-0014; FDIC RIN 3064-AD85; SEC File No. S7-41-11 CFTC
RIN 3038-AC**

Dear Chairman Bernanke,

The Bank of Canada is responsible for monetary policy and is the ultimate supplier of Canadian dollar liquidity. It also acts as fiscal agent for the Government of Canada, with responsibility for managing the federal debt program. Given the importance of Canadian financial markets in fulfilling its responsibilities, the Bank of Canada has a strong interest in regulatory developments that may affect the functioning, liquidity and resilience of these markets. Thus, the Bank of Canada appreciates the opportunity to provide comments on the proposal regarding *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (the “proposed rule”) to implement Section 619 of the Dodd-Frank Act (the “Volcker Rule”).

The Bank of Canada supports the Volcker Rule’s objective to “protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities.”

However, the proposed rule appears to extend well beyond U.S.-insured depository institutions and imposes significant restrictions on Canadian banking entities by limiting their use of U.S.-based resources, personnel and market infrastructure and by preventing them from trading with U.S. counterparties.

These restrictions may have important adverse consequences for Canada, limiting the liquidity of Canadian markets and hence the resilience of the Canadian financial system. Indeed, the proposed rule may undermine, rather than support, progress toward creating a safer, more resilient and more efficient global financial system.

The remainder of this letter explains three potential consequences of the proposed rule and offers proposed amendments.

Market-making and risk-management activities by Canadian banks may be limited.

The proposed rule provides exemptions for activity that is “solely outside of the United States” as well as for market-making and risk-management activities. It appears that Canadian banks’ trading activities would be limited to those activities that qualify for one of these exemptions. As currently written, the exemptions are narrow and may prevent a great deal of trading activity that supports financial stability and efficiency in Canada. The compliance regime for identifying permitted trading activities also places a significant burden on Canadian banks.

Canadian banks may limit hedging, market-making and underwriting activities involving U.S.-based resources and U.S. counterparties to avoid potential non-compliance with the proposed rule. The difficulty of distinguishing legitimate market-making activities from prohibited proprietary trading could reduce trading activity and could severely disrupt the liquidity and resilience of Canadian financial markets.

Canadian banks play a critical role not only in traditional lending but also across Canadian financial markets. Market funding supplies about two-thirds of Canadian businesses’ overall financing needs. These markets enhance competition and transparency and enable greater diversification and a more efficient allocation of risk. The banks’ market-making activities are essential to maintaining deep and liquid markets that support the ability of Canadian corporations and public entities to obtain timely and cost-effective funding.

Trading in Canadian government bonds may be impaired, restricting competition and liquidity in these markets.

The U.S. Financial Stability Oversight Council justifies the exclusion of U.S. government securities from restrictions on proprietary trading in the Volcker Rule by stating “Banks serve as a critical source of liquidity in these markets. In addition, these instruments

have historically served a significant role in traditional banking activities, providing a low-risk, short-term liquidity position and are a commonly utilized source of collateral in transactions.”¹

The same reasoning applies to government securities in other jurisdictions, and these securities should therefore be excluded from the proprietary trading restrictions of the proposed rule. Without this clear exemption, the proposed regulations could restrict Canadian banks’ transactions in Canadian government securities involving U.S. infrastructure or counterparties. Similarly, the restrictions on U.S. banks’ participation in the market for Canadian government securities would restrict competition and liquidity in these markets and ultimately undermine the resilience of the Canadian financial system. In Canada, approximately 20 per

¹ Financial Stability Oversight Council, “Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds,” study completed pursuant to section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, January 2011.

cent of all government debt is held by non-residents. Notably, U.S. residents are counterparties to over two-thirds of transactions in Canadian bonds with non-residents.

It would be a particular concern if other jurisdictions enacted legislation with a similar home bias. The result would be a fragmentation of global capital markets, reducing their liquidity, financial stability and economic efficiency.

The use of U.S.-based global market infrastructure may be curtailed, hindering progress in implementing global initiatives to promote financial stability.

Based on the proposed language, it would appear that the “solely outside of the United States” standard could prevent Canadian banks from engaging in some trading that incidentally uses financial infrastructure located in the United States. This could apply to trading and post-trade infrastructure provided by NYSE Euronext, NASDAQ, the CME Group and the Depository Trust & Clearing Corporation. As drafted, the proposed rule could hinder progress in implementing global initiatives to promote financial stability, such as increased use of trading platforms and central clearing for over-the-counter derivatives, particularly to the extent that no substitutes are available for such U.S.-based infrastructures. The rule could also create incentives for Canadian banks and other foreign financial institutions to move transactions away from U.S.-based systems, exchanges and central counterparties, likely reducing liquidity in U.S. markets.

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To summarize, the Bank of Canada’s principal concern is that the proposed rule will restrict the activities of Canadian banks, which are critical to the functioning of Canadian financial markets and, by extension, the Canadian financial system. If adopted as currently drafted, the Volcker Rule may limit market-making and risk-management activities by Canadian banks; limit trading in Canadian government bonds; and hinder the implementation of global initiatives to promote financial stability.

Two changes to the proposed rule may reduce these unintended consequences:

- 1) In response to Question 138 of the proposed rule, **satisfaction of the “solely outside of the United States” exception should be predicated upon whether the activity entails risk for a U.S.-insured depository institution and not incidental connections with U.S. entities or infrastructure.** Canadian banks should not be subject to narrow classifications of permissible market-making and hedging activities for transactions that do not bring risk to the U.S. financial system. The Canadian banks’ prudential regulator, the Office of the Superintendent of Financial Institutions, already supervises Canadian financial institutions, including all subsidiaries in Canada and abroad, using a comprehensive, risk-based methodology, which is applied on a consolidated basis. The proposed rule should rely on Canadian regulators to ensure the soundness of Canadian institutions and their trading practices, consistent with the long history of co-operation and mutual respect between Canadian and U.S. regulators and the demonstrated resilience of the Canadian financial system during past periods of global financial stress.

- 2) In response to Question 122 of the proposed rule, **Canadian government securities, including securities issued or guaranteed by the federal and provincial governments, should be exempt from proprietary trading restrictions.** This exemption would maintain competition in Canadian government bond markets, increase liquidity, be consistent with the long history of equal treatment of institutions in our respective government bond markets and support the continued financial resilience of Canada, the United States' largest trading partner.

In closing, I would like to reiterate that the Bank of Canada shares your overall objective of ensuring the soundness of the U.S. and global systems. However, I would urge you, in finalising these rules, to take into consideration the interconnectedness of the Canadian and U.S. financial systems, the potential for unintended impacts on the Canadian financial system and the possibility that the rule, as currently drafted, could reduce global financial resilience rather than increase it.

The Bank of Canada would welcome further opportunities to discuss how to implement the Volcker rule in a manner that preserves global financial stability. If you have any questions or require additional information, please contact me or Timothy Lane, Deputy Governor, at 613-782-7101 or by email at tlane@bankofcanada.ca. Thank you for your consideration of these important issues.

Sincerely,



c.c.:

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