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# INVESTURE

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126 Garrett Street, Suite J  
Charlottesville, Virginia 22902  
T: 434.220.0280  
F: 434.220.0285  
W: [www.investure.com](http://www.investure.com)

January 17, 2012

Department of the Treasury  
Office of Domestic Finance  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20520

Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, N.W.  
Washington, D.C. 20429

Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street & Constitution Avenue, N.W.  
Washington, D.C. 20551

Office of the Comptroller of the Currency  
250 E Street, S.W.  
Washington, D.C. 20219

Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20551

Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

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

Dear Madams/Sirs:

Investure LLC<sup>1</sup> strongly supports regulatory reform and the efforts of the Office of the comptroller of the Currency, Treasury (“OCC”), Board of Governors of Federal Reserve System (“Board”); Federal Deposit Insurance corporation (“FDIC”); and Securities and Exchange Commission (“SEC”) (collectively the “Agencies”) to promulgate appropriate rules (the “Proposal”) to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). We appreciate having the opportunity to comment on the Proposal and, as described in more detail below, believe that significant changes to the approach taken by the Agencies are necessary, particularly with respect to the provisions effectuating the market making exemption contained in the Dodd-Frank Act.

Market marking is a core function of banking entities and provides liquidity needed by all market participants, including the pension funds and endowments that we represent. We believe it is crucial that the steps mandated by the Dodd-Frank Act be implemented in a manner that does not disrupt the

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<sup>1</sup> Investure LLC (“Investure”) is the outsourced investment office for 13 endowments and foundations with approximately \$8.1 billion under management as of November 30, 2011.

liquidity necessary for functioning securities markets and impose potentially prohibitive costs and burdens on market participants.

### **Impact of the Proposal on Market Making activities**

While Section 619 of the Dodd-Frank Act generally prohibits any “covered banking entity” from engaging in “proprietary trading,” there are certain statutory exceptions. The legislation specifically provides an exemption for “*The purchase, sale, acquisition, or disposition of securities and other instruments.....in connection with underwriting or market-making-related activities.....*”.

Rather than acknowledge this tenant and setting forth broadly applicable standards to govern permitted market marking activist, the Proposal creates a presumption that any covered financial position that a covered banking entity holds for a period of sixty days or less is a prohibited proprietary transaction. While the presumption is “rebuttable” we respectfully submit that the framework for rebutting the presumption contained in the Proposal and accompanying documentation is unworkable for many reasons, including: (i) an inability to predict the financial impact of market making activities for purposes of complying with the metrics set forth in the Proposal; (ii) the failure of the Proposal to identify and account for different types of market making environments, particularly those related to the fixed income markets and other OTC markets; (iii) the creation of perverse incentives through mandates on how compensation is calculated; and (iv) the onerous and potentially contentious compliance mandates that could encourage covered banking entities to abandon less liquid and more volatile segments of various markets.

With respect to (ii) above, we believe that the Proposal was drafted solely from the perspective of regulated market making activities in organized markets where intermediaries generally act as agents, such as those for listed securities. The description of market making activities set forth in the Proposal clearly do not take into account unregulated over-the-counter market making activities that covered banking entities provide to these markets, which require intermediaries to regularly trade as principal due to the high degree of fragmentation and intermittent liquidity of said markets. While our comments reflect our view as to the application of the Proposal to all markets, one of our greatest concerns is the devastating effect that the Proposal would have on the fixed income markets that exhibit intermittent liquidity and thus require market makers to act as principal in order to ensure liquidity. We respectfully submit that the failure to take into account over-the-counter market making activities reflects a major oversight and must be addressed in the final analysis and rulemaking.

In summary, we believe that the inability to confidently engage in market making activities on a principal basis under the Proposal, along with the onerous recordkeeping and compliance burdens required will have a material and detrimental impact on the ability of covered banking entities to engage in market making activity. The Proposal, as drafted, will likely dramatically reduce market liquidity, increase costs and in some cases impact the ability of market participants to meet their legally required obligations to end investors and other stakeholders.

A more detailed explanation of some of our concerns is set forth below.

## **Holding Period**

The Proposal generally prohibits a covered banking entity from acting as principal in the purchase or sale of a covered financial position for its own trading account. As noted above, the Proposal creates a presumption that any account that holds a covered financial position for a period of sixty days or less is a trading account and thus such transaction is prohibited. The Proposal allows this presumption to be rebutted if the covered banking entity can demonstrate that the position was not acquired principally for any of the purposes listed. We submit that the combination of this negative presumption combined with rebuttals that may be difficult (if not impossible) to demonstrate, will provide a strong incentive to covered banking entities to dispose of each and every position as quickly as possible in order to avoid any taint that could result in the transaction being considered a prohibited proprietary transaction.

As a result, covered banking entities are going to be reluctant to make a market in any securities they are not reasonably confident they can dispose of immediately. Additionally, intermediaries will be forced to build a larger bid/ask spread into their pricing in order to offset the added risks and costs involved. Not only will this larger spread have a negative impact on market participants, but market participants will now interact with trading and other client facing personnel that are incentivized under the Proposal to maximize the spread on individual transactions without concern for the underlying profitability of the trade. The reason for this incentive is found in the Proposal's prohibition on a covered banking entity compensating employees, including traders, for engaging in proprietary risk taking. The likely outcome is that traders will be incentivized on the basis of the income they receive from the spread received from their clients rather than the profitability of their book – a perverse arrangement that likely will encourage employees to overcharge their clients.

The final rules must take into account the fact that market making often involves the need to take short-term positions that will result in profit and loss. This activity is distinguishable from proprietary trading activity and is the natural economic result flowing from the willingness of the market maker to commit capital to facilitate orderly trading. Moreover, this is a necessary requirement for functioning markets.

## **Hedging**

The Proposal appears to rely heavily on the use of hedging as a means of enabling market makers to offset the risk associated with taking short term positions and, perhaps more importantly in the context of compliance with the Proposal, avoid realizing profit and loss in connection with positions held as a market maker. The Proposal ignores reality by assuming that there are perfect hedges for all securities. Certainly there are segments of fixed income markets and OTC markets where such hedges do not exist or markets where even the best structured hedges fail to protect the hedging party fully. It is impossible to predict what the behavior of even the most highly correlated hedge will be versus the underlying asset being hedged. In general, the realization of some profit and loss is unavailable even when a market maker commits capital to facilitate orderly trading of liquid securities with properly structured hedges. Also, as is the case with all of the requirements of Proposal, each trade is looked at individually, which multiplies the probability that a covered banking entity is deemed to have engaged in a prohibited activity.

Given these facts, and the emphasis the Proposal places on avoiding profit or loss on positions taken by market makers, intermediaries are not going to be able to place great confidence in the use of hedging as a means of staying within the exemption.

### **Compliance Costs and Burdens**

As noted previously, the Proposal states with the presumption that taking a position for a period of sixty days or less is a prohibited proprietary transaction. While the market-making exemption provides a mechanism for rebutting this presumption, this involves analyzing the market making activity of a covered banking entity on almost a transaction by transaction basis. Not only would the compliance program, tasked with preventing prohibited proprietary trading, be extremely complex, onerous, and require a significant build-out of resources, manpower and systems, but the process would be vulnerable to hindsight interpretations that fail to capture or downplay important facts and color that justified the trade at time of execution.

The operational burdens and costs associated with this process are going to be magnified by the costs involved in providing all the new reports and tracking the information that the covered banking entities are required to provide. The compliance process will also require numerous performance and profit/loss calculations in order to track the many metrics enumerated in the Proposal. Additionally, given the presumption created by the Proposal, there is the risk, given the dynamics of a particular firm, that the compliance process could become a contentious and adversarial process with compliance focused on generating reasons why a transaction should be classified as prohibited activity.

### **Impact on Open End Mutual Funds**

Mutual Funds account for a substantial percentage of the investable assets in the U.S. The liquidity needs of open end mutual funds are largely driven by the need to respond to both redemptions and subscriptions. Section 22(e) of Investment Company Act of 1940 requires open end funds to meet redemptions requests within seven days and limit the ability of open end funds to borrow money to fund redemptions. Effectively, during a period of material redemptions a fund is a forced seller of securities and during a period of heavy inflows a fund is more or less a forced buyer. Currently mutual funds can rely on intermediaries to commit capital and facilitate an orderly market. This not only benefits funds and their managers, but it ultimately benefits the millions of small investors that are served by the mutual fund industry. Implementation of the Proposal will immediately convert a significant number of these intermediaries from market makers, in the sense we see them now, to themselves being forced sellers or buyers of securities they are still willing to make markets in. Not only will this immediately impact funds in terms of higher trading costs and reduced liquidity, but in certain markets it may also impact the overall value of the securities traded due to long term uncertainty about available liquidity.

### **“High Risk” Assets**

The Proposal prohibits any transaction that results in material exposure to “high-risk assets”. The Proposal defines a “high-risk asset” as an asset or group of asset that would, if held by the covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail. We respectfully submit that this is unacceptably vague and open

ended. To put the danger of moving forward with such an open-ended definition into perspective, we submit that during 2008, many of the securities traded in the mortgage market and other financial markets would likely have been characterized as a "high risk asset" under the relevant language of the Proposal. It is vital for our markets that regulation not force market makers to exit their markets in times of stress and yet this is exactly what would happen if the Proposal is adopted as written. When considering a definition for "high risk assets", we encourage the Agencies to consider whether their definition would have forced covered banking entities to exit markets during the recent financial crisis. It is very clear that the intent of the Dodd-Frank Act is not to constrain liquidity during times of crisis since this would exacerbate the impact upon the economy.

### **Exception for Government Securities**

The Proposal describes the government obligations in which a covered banking entity may trade notwithstanding the prohibition on proprietary trading, which include U.S. government and agency obligations, obligations and other instruments of certain government sponsored entities, and state and municipal obligations. We respectfully submit that to still allow covered banking entities to accumulate significant risk in these markets in a manner that is not readily distinguishable from the risk associated with other asset classes, such as corporate bonds, is not reconcilable. On the one hand, the Proposal recognizes the importance of maintaining liquidity and access to capital for the US government, while on the other hand, the Proposal, as currently drafted, clearly limits liquidity and access to private capital for the businesses across the country. In short, we do not see the basis for permitting bank-owned broker dealers to assume risks for providing unrestricted liquidity for US Government Obligations and other government related obligations, while prohibiting them from assuming the same risks for non-Government debt.

### **Costs Versus Benefits**

Assuming the Proposal is adopted in its current form, we believe that liquidity and trading costs will be significantly and adversely impacted. Implementation of the Proposal would, in our opinion, cause massive dislocation with no assurance that the outcomes they are designed to prevent will be avoided. What we can be certain of is that the U.S. economy will be forced to bear both short-term and long-term costs associated with the reduction in market liquidity.

### **Economic and Competitive Risks**

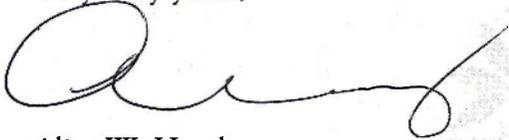
Based on the concerns and examples we have set forth, we believe implementation of the Proposal will have serious negative implications for the cost of capital to U.S. businesses, liquidity in the U.S. financial markets and the U.S. economy. Implementation should also be examined in the context of the global financial markets, recognizing the risk that financial activity may migrate to the unregulated shadow banking system or to foreign financial centers such as Hong Kong, Singapore, London, Frankfurt, Paris or Zurich, and the resulting negative effects on the strength and competitiveness of the United States as a global financial center.

## Conclusion

If the Proposal is adopted in its current form, it can reasonably be expected that covered banking entities will be forced to exit market making for all but the most liquid of securities. While this may be a desired effect of the Proposal, ignored is the fact that much of the current market making activities in this country are provided by covered banking entities. The short time frame provided for the covered banking entities to implement the Act almost insures a dramatic reduction in liquidity in the marketplace, as there does not now exist enough captiancy among non-bank market makers to provide the necessary liquidity to the markets abandoned by the covered banking entities. The economic impact at a time when the economy is struggling is worrisome. Long term, we are concerned that a potential unintended consequence of the Proposal is that much of the market making activities currently provided by the covered banking entities may over time relocate offshore, along with much needed jobs.

We strongly urge the Agencies to re-think the approach taken in the Proposal by addressing the points raised in this letter in order to create a regulatory framework that accomplishes the narrow mandate of Section 619 of the Dodd-Frank Act, to prohibit "proprietary trading" by covered banking entities, without adversely affecting the efficient functioning of U.S. markets.

Very truly yours,



Alice W. Handy  
President and CEO

