

# JPMORGAN CHASE & CO.

Barry L. Zubrow  
Executive Vice President  
Corporate and Regulatory Affairs

February 13, 2012

*By electronic submission*

Department of the Treasury  
Office of Domestic Finance  
1500 Pennsylvania Avenue NW  
Washington, DC 20520

Board of Governors of the Federal Reserve  
System  
20<sup>th</sup> Street and Constitution Avenue NW  
Washington, DC 20551

Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street NW  
Washington, DC 20429

Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549

Office of the Comptroller of the Currency  
250 E Street SW  
Washington, DC 20219

Re: Comment Letter on the Notice of Proposed Rulemaking Implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Ladies and Gentlemen:

JPMorgan Chase & Co. appreciates the opportunity to comment on the joint notice of proposed rulemaking<sup>1</sup> issued by your agencies to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, also known as the Volcker Rule.

## Overview

Our company is affected by the proposed rule in numerous ways. Through JPMorgan Chase Bank, N.A., J.P. Morgan Securities LLC and other affiliates, we engage in market making in a wide range of securities and derivatives; through the various legal entities that comprise J.P. Morgan Asset Management, we offer investment solutions to our clients through funds and other products; and at the corporate level, our Chief Investment Office is responsible for making investments to hedge the structural risks of our balance sheet on a consolidated basis.<sup>2</sup>

---

<sup>1</sup> 76 Fed. Reg. 68846 (November 7, 2011).

<sup>2</sup> We will refer to JPMorgan Chase & Co. and all its subsidiaries collectively in this letter as "JPMorgan," or the "Firm."

In each of these areas, we believe that the proposed rule would have serious, adverse effects on our ability to manage our risks and address the needs of our clients, and on market liquidity and economic growth. While the proposed rule would require us to eliminate pure proprietary trading and limit our hedge fund and private equity fund investing, we believe those intended effects will have significantly less impact on the Firm than the indirect and unintended effects on market making, asset-liability management and asset management for customers.

Section 619 does not prohibit most risk taking by banking entities. Risk taking is necessary for us to help American businesses finance and manage economic growth. Rather, the statute by its terms prohibits a particular category of risk taking that its drafters determined was not appropriate for banking entities. That type of risk taking is short-term speculative risk taking, either directly through certain types of proprietary trading or indirectly by means of investing in private equity or hedge funds. Other areas where banking entities take risk – even significant risk, for example, by making loans – are not covered by the statute, and do not need to rely on its exceptions to continue.

We have two core concerns with how the proposed rule has interpreted the statute. First, it has in some areas turned the statute's narrow prohibition into a more general prohibition on risk taking, and put banking entities in the position of having to rely on ambiguous or incomplete exceptions to the proposed rule in order to continue some of their core functions. Thus, the proposed definition of trading account, which is part and parcel of the definition of proprietary trading, would appear to apply to many types of trading and asset-liability management activities beyond just those focused on short-term price movements. The statute clearly focuses on hedge funds and private equity funds, and a study by the Financial Stability Oversight Council<sup>3</sup> warns against the potential impact of a more expansive definition. Nonetheless, the proposed rule broadens the statutory definition to encompass securitization structures, potentially all non-U.S. funds sponsored by or invested in by U.S. banking entities, including the foreign equivalents of U.S. mutual funds, and almost all wholly owned subsidiaries.

Second, the proposed rule appears to take the view that banking entities, their customers, and the economy must pay almost any price in order to ensure absolute certainty that there can never be an instance of prohibited proprietary trading. The proposed rule appears to presume that banking entities will camouflage prohibited proprietary trading to evade the rule, and that extraordinary efforts are necessary to prevent this behavior.

We believe that the statute mandates a very different approach. The statute clearly sets forth Congressional intent as to how it is to be implemented. The statute directs the FSOC to study and make recommendations to the agencies on implementation so as to:

---

<sup>3</sup> "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds," Financial Stability Oversight Council (January 2011) (the "FSOC Study").

- promote and enhance the safety and soundness of banking entities;
- minimize the risk that banking entities will engage in unsafe and unsound activities;
- limit the inappropriate transfer of Federal subsidies from banks to unregulated entities;
- reduce conflicts of interest;
- limit activities that have caused undue risk or loss.<sup>4</sup>

We believe that all of these policy goals could be addressed by a final rule that imposes dramatically fewer costs to liquidity, market efficiency and safety and soundness than the one proposed. There are numerous other laws established to serve many of the same purposes – everything from margin requirements to Section 23A of the Federal Reserve Act to concentration limits to risk-based deposit insurance premiums. The same goals appear to have motivated these laws, yet none of them have been implemented through an intrusive compliance regime and with a resulting chill on legitimate economic activity.

The concerns we express are not unique to our Firm or even to the banking industry. We have heard them from our clients, including businesses, asset managers, and foreign nations – all of which see the proposed rule as impairing their ability to fund themselves and manage their risks. The agencies are not required by section 619 to impose these costs, and we urge them to revisit the proposed rule with them more firmly in mind.

We acknowledge the serious challenges that the agencies face in implementing the statute. For example, the issues with the proposed restrictions on fund activity derive from a core problem: Congress did not define with any precision what constitutes a “hedge fund” or a “private equity” fund. We believe that the proposed rule makes matters worse by increasing rather than decreasing the scope of the term “covered fund,” and by unnecessarily exporting these problems to overseas funds and bank subsidiaries. Similarly, as detailed below, distinguishing proprietary trading from market making is difficult, particularly with respect to market making in illiquid instruments. We believe that a prohibition on bright-line proprietary trading, as set forth in the FSOC study,<sup>5</sup> would have been a good solution, and consistent with the statute. However, once the regulators determined that a broader, more quantitative enforcement regime was needed, any such regime would, as a consequence, be necessarily complex, and our comment does not fault the complexity in this part of the rule. Rather, we focus on how certain aspects of the regime are particularly likely to chill legitimate market making and impose needless costs. Finally, in its unduly constrained approach to asset-liability management, the proposed rule may undermine banking entities’ safety and soundness.

---

<sup>4</sup> Section 619(b)(1). The section also provides guidance on accommodation of insurance companies and divestiture of assets that are not relevant here.

<sup>5</sup> See FSOC Study at pages 27-28.

The Volcker Rule is made far more damaging by the fact that no other country has adopted anything like it. Capital markets are global, and a typical institutional client has relationships with multiple banks, many of which are foreign banks; U.S. financial banking entities, therefore, will suffer competitively from the Volcker Rule. Furthermore, U.S. companies that lack the ability to fund themselves in overseas markets should not be put at a disadvantage to foreign companies that can access markets where the liquidity providers are not subject to the Volcker Rule and, therefore, are more liquid and efficient.

The Firm supports comments on the proposed rule being submitted by the Securities Industry and Financial Markets Association, The Clearing House Association, the American Securitization Forum, the Loan Syndications & Trading Association and the International Swaps and Derivatives Association. Those comments detail numerous issues created by the proposed rule, and how many of its components appear to conflict with the language and purpose of the statute, and impose high costs on banks, their customers, financial markets and the economy as a whole. In this comment letter, we will not replicate all those points but rather focus on some and provide examples from our own experience to highlight major concerns about the proposal.

We do believe that the extraordinary complexity of the proposal, the hundreds of questions asked in the preamble, and the breadth and depth of proposed changes the agencies are likely to receive mean that the next version of the rule should and likely will differ materially from the first. Accordingly, we believe that those parts of the proposed rule that have elicited the most comment, and presumably will have undergone the most change, should be republished for comment to ensure that efforts to fix one problem have not created another. While we recognize that the statute will take effect in July regardless of the status of the rulemaking, we believe that both regulated entities and the agencies have experience implementing statutes without a complex rulemaking to guide them, and could do so in this case. We believe that the FSOC's definition of bright-line proprietary trading could be adapted as the basis for an interim rule with respect to that aspect of the rule. With regard to funds, an interim final rule could identify those types of funds that are clearly traditional hedge funds or private equity funds while seeking further comment on any new definition that expands the definition to categories of "similar funds."

Ultimately, we believe that the statute is so flawed that it will be impossible to implement in a way that does not impose unacceptable costs on our economy and financial system. Other regulatory and supervisory actions, as well as secular industry reforms – including extraordinarily high capital, liquidity and other requirements related to derivatives and other trading assets; improved underwriting standards; and permanent changes to the securitization landscape – impose more than sufficient restraints on the types of risk taking that are the Volcker rule's focus.

We note that the statute and proposed rule permit proprietary trading in U.S. Government securities, presumably because of a belief that trading in those securities benefits their liquidity and reduces the cost to their issuer, the U.S. Government. Foreign nations are now

seeking a parallel exemption from the rule, citing precisely those reasons and expressing concern about what restrictions on trading will mean for the liquidity and pricing of their securities. U.S. companies are expressing the same concern with respect to their securities, further highlighting the potentially significant cost of the statute.

Those concerns highlight the extraordinary difficulties of proscribing proprietary trading while protecting client-driven and risk-mitigating trading activities. Nevertheless, we do not propose to debate the merits of the underlying statute in this letter. Instead, our comments focus on the potential implications of the proposed rule for our client franchises and risk management activities.

Our letter covers some general comments and then is divided into three main sections:

- First, a discussion that the market-making-related permitted activity is drafted too narrowly, and would deprive markets of valuable liquidity.
- Second, a discussion that the proposed definition of covered fund exceeds the statutory mandate by applying its restrictions abroad, and would thereby do unnecessary harm to the competitiveness of U.S. firms and investors.
- Third, a discussion that a combination of provisions could impair the ability of banking entities to engage in asset-liability management, including liquidity risk management, and an exemption for asset-liability management is therefore necessary to safeguard adverse effects on safety and soundness.

## TABLE OF CONTENTS

---

	<u>PAGE</u>
I. General Comments.....	7
A. Trading Account.....	7
B. Supervisory Implementation .....	8
C. Need for Phased Implementation .....	8
II. Proprietary Trading and Investment Banking Activities.....	10
A. Market Making .....	13
B. Risk-Mitigating Hedging Permitted Activity .....	23
C. The Extraterritorial Application of the Volcker Rule Would Create Competitive Disadvantages among U.S. Firms.....	26
D. Government Obligations Permitted Activity.....	27
E. Commodity Forwards Should Not be Included in the Final Rule.....	28
F. Loans .....	29
G. The Proposed Definition of Covered Funds Would Disrupt Certain Lending Activity .....	31
H. Repurchase and Reverse Repurchase Agreements.....	34
I. The Statute's Exceptions Apply to All Activities It Covers.....	35
J. Compliance Program.....	35
III. Funds and Asset Management Activities.....	36
A. Foreign Funds.....	37
B. Corporate Bonds.....	47
C. Public Welfare Investments Abroad.....	49
IV. Asset-Liability Management.....	50
A. Asset-Liability Management is a Foundation of Safety and Soundness .....	50
B. Many ALM Activities Would be Captured by the Definition of Trading Account .....	52
C. Deficiencies in the Risk Mitigation Hedging Exemption.....	54
D. Inapplicable Elements of the Risk Mitigation Hedging Exemption.....	59
E. The Liquidity Management Exclusion .....	61
F. Alternative approach .....	63
Appendix A – Compliance Program for Foreign Funds	

## I. General Comments

### A. Trading Account

The statute defines proprietary trading as “engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate [regulators] may . . . determine.”<sup>6</sup> This definition would seem to ban a wide range of risk taking by banking entities. The definition is significantly and necessarily narrowed, however, by its reference to “trading account,” which is in turn defined as comprising “any account used for acquiring or taking positions in [covered instruments] . . . 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)”<sup>7</sup> or other accounts that the agencies may by rule decide to cover.

Thus, the definition of “trading account” is where Congress actually made clear what it meant by proprietary trading. And Congress made clear that it viewed proprietary trading as having in all cases a focus on earning profit from short-term price movements. It thereby distinguished impermissible proprietary trading from longer term investment activity and asset-liability management. The proposed rule defines “trading account” by reference to three separate tests: a purpose test (which tracks the statute and includes a rebuttable presumption that any position held for less than 60 days was taken with short-term trading intent); a market risk capital test (which substantially incorporates the definition of a “trading book” under proposed Basel capital rules); and a status test (if the activity requires registration as a dealer then the status test is fulfilled). If any one of the three tests is satisfied, the particular account will be a trading account (unless one of the three exceptions set forth within the trading account definition applies).

The preamble to the proposed rule indicates that the agencies added the market risk capital test on the assumption that its coverage was effectively the same as the purpose test, and to reinforce consistency between the proposed rule and the market risk capital rules, and to “eliminate the potential for inconsistency or regulatory arbitrage.”<sup>8</sup> We believe, however, that the proposed market risk capital test does capture additional types of trading that are not within the purpose test, and types of trading that clearly should be permissible. The status test does as well. Accordingly, we suggest the agencies revert to the statutory definition.<sup>9</sup>

---

<sup>6</sup> Section 619(h)(4).

<sup>7</sup> Section 619(h)(6).

<sup>8</sup> See proposed rule at page 68859.

<sup>9</sup> If the agencies do wish to proceed with a separate market risk capital test, they would need to reopen this rulemaking in order to resolve what would otherwise appear to be significant procedural issues. Not only has the

## **B. Supervisory Implementation**

The statute creates a supervisory role for five separate regulators. The proposed rule suggests no means by which the supervisory efforts of those agencies should be coordinated. As the statute notes, inconsistent application or implementation of regulations could create competitive advantages and disadvantages among entities affected by its terms.<sup>10</sup>

This jurisdictional ambiguity is not simply an awkward issue for the agencies, but rather, if permitted to continue in the final rule and its implementation, it will also be a significant problem for markets. The proposed rule already vests extraordinary discretion in the regulators, and makes it very difficult for a banking entity to know whether trading will be considered permissible (whether as market making, underwriting, asset-liability management or otherwise) or impermissible as proprietary trading. Interpretations are likely to vary over time, and one examiner at an agency may take a different view from another. Political considerations may change views of what is permissible. A whole additional layer of uncertainty is added, though, if the same trading unit at a given banking entity is subject to interpretation by examiners at a multitude of agencies. A trader at a national bank subsidiary of a bank holding company that registers as a swap dealer faces the prospect of having a vague and politically charged rule interpreted by four different agencies for purposes of his or her trading.

We recommend that before this rule is finalized, the agencies adopt and seek comment on a protocol for supervision and enforcement that ensures that a given banking entity will face one set of rules, and that different banking entities will face the same set of rules. Failure to do so will result in even greater chilling of legitimate trading, and even greater damage to market liquidity, funding for U.S. businesses, and economic activity.

We are less concerned with who makes the rules here than with the consistency of the application of those rules, though we believe that because these restrictions have safety and soundness as their primary focus, the banking regulators would seem to have the most relevant experience as well as having the examination resources.

## **C. Need for Phased Implementation**

Regardless of how the final rule turns out, it will be a shock to the U.S. financial system, as banking entities will need to take extraordinary measures to attempt to implement it, counsel traders on what is permitted and what is not, and establish a cumbersome compliance regime. Both banking entities and regulators will need to learn how as many as seventeen metrics work when used, for the first time, to distinguish government-approved trading from

---

proposed rule here not provided notice as to how that test would expand the statutory definition, the market risk capital test is currently only a proposed rule, and is subject to change. See proposed rule at page 68859; Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890 (January 11, 2011).

<sup>10</sup> See Section 619(b)(2)(B)(ii).

government-prohibited trading. The risk posed to the U.S. economy by a hurried implementation of the Volcker Rule is significant. We encourage the agencies to adopt a gradual approach to implementation of the final rule. In particular:

- The agencies should use the initial conformance period to develop a complete understanding of the range of activities conducted by banking entities that require the assumption of principal risk and how those activities are distinguishable from prohibited proprietary trading. The initial conformance period should be used exclusively to collect and analyze data concerning those activities and bright-line proprietary trading activities and to develop appropriate quantitative tools to test for compliance with the proprietary trading prohibition after the expiration of the initial conformance period.
- The following sentence should be removed from the final rule because it has created considerable confusion as to the availability of the initial conformance period for banking entities to conform their activities to the statute and appears at odds with the Board's Conformance Rule:

The agencies expect a banking entity to fully conform all investments and activities to the requirements of the proposed rule as soon as practicable within the conformance periods . . .

- The final rule should require banking entities to use reasonable efforts to begin furnishing metrics as of the first anniversary of the effective date and state that the provision of such reports during the initial conformance period is without prejudice to the ability of a firm to rely on the full initial conformance period with respect to its activities.

The sole recommendation of the recent GAO study on proprietary trading was that regulators should collect and review more comprehensive information on the nature and volume of activities potentially covered by the statute in order to ensure that it is implemented effectively.<sup>11</sup> The initial conformance period is an opportunity for agencies to adopt a heuristic approach not solely with respect to the quantitative measurements in Appendix A to the proposed rule, but with respect to implementation of the statute as a whole. We encourage the agencies to use the initial conformance period for that purpose.

The proposed rule has created considerable confusion concerning the initial conformance period. As the proposed rule notes more than once, the purpose of the initial conformance

---

<sup>11</sup> See GAO Report to Congressional Committees, "Proprietary Trading – Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented," July 2011 (the "GAO Study") ("In order to improve their ability to track and effectively implement the new restrictions on proprietary trading and hedge fund and private equity fund investments, we recommend that the Chairperson of FSOC direct the Office of Financial Research, or work with the staffs of the Commodity Futures Trading Commission, FDIC, Federal Reserve, OCC, and SEC, or both, to collect and review more comprehensive information on the nature and volume of activities that could potentially be covered by the act.").

period is to give markets and banking entities an opportunity to adjust to the statute. The purpose of the Board's Conformance Rule, which took effect on April 1, 2011,<sup>12</sup> was to implement the conformance periods. While the proposed rule states that the Board is not proposing any substantive changes to the Board's Conformance Rule, such a substantive change is arguably made by the statement that the agencies expect a firm to fully conform all investments and activities to any final rule as soon as practicable within the conformance periods. No such statement is made or implied in the Board's Conformance Rule. Furthermore, to the extent that the statement implies that a firm may not be permitted to rely on the full initial conformance period, it appears inconsistent with Congressional intent.

Any version of the compliance program outlined in the proposed rule would require a significant systems build-out. We believe that few, if any, banking entities could have completed that build-out by the effective date even if the final rule had been issued in October 2011, as required by the statute. The statement imposes an unrealistic and, given the existence of the initial conformance period, unnecessary burden on banking entities. We agree, however, with the statement in the proposed rule that the metrics can only be usefully identified and employed after a process of substantial public comment, practical experience, and revision. We believe that a full year's worth of data would be sufficient to allow the agencies to refine the suite of metrics.

## **II. Proprietary Trading and Investment Banking Activities**

Regulated banking entities are by far the largest providers of market-making services. The existence of a robust, competitive field of such entities willing to provide liquidity is essential to create secondary market support for investments like corporate and municipal bonds. The statute has created considerable uncertainty about the market-making-related services that these entities can continue to provide. Further, while the statute clearly identifies the promotion of safety and soundness as one of its primary objectives and specifically protects market-making-related activities, the proposed rule appears more heavily focused on the prospect of banking entities hiding prohibited behavior. Consequently, it proposes to operate with a disruptive level of granularity and fails to provide banking entities with a sufficiently clear path to compliance. We believe that, if implemented as drafted, the proposed rule could have a chilling effect on the provision of liquidity by market makers that, in turn, would impair capital formation. Our principal concerns and recommendations concerning the market-making-related aspects of the proposed rule, each of which is described in more detail below, can be summarized as follows:

- The final rule should establish a rebuttable presumption that if the metrics required by the rule demonstrate that a business is a market-making business then the business in question is in compliance with the final rule.

---

<sup>12</sup> See Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (February 14, 2011).

- The proposed rule regarding market-making should not rely on hard-coded criteria; instead, some of the criteria included in the proposed rule should be moved to an appendix as guidance to banking entities on how to distinguish permitted market-making-related activities from prohibited proprietary trading.
- Metrics should be applied at a less granular level, with longer observation periods, a frequency that more closely reflects typical banking operations and more statistically appropriate calculation periods. For some metrics, the proposed implementation set out in the proposed rule is dramatically more difficult than necessary, and will yield negligibly more insight than a less burdensome version.
- While the statute very clearly permits the purchase, sale, acquisition or disposition of securities and other instruments in connection with market-making-*related* activities, the proposed rule appears to permit only transactions that are, themselves, market making. We believe that this fails to give full effect to Congressional intent with respect to the protection of critical aspects of a market maker's activities, such as certain arbitrage activities.
- The proposed rule puts unnecessary restrictions on interdealer trading, which is an important component of market making. The agencies should make clear that, whether or not conducted on an organized trading facility or exchange, interdealer trading driven by liquidity needs is market-making-related activity and is permitted. The agencies should clarify that the nature of the trading relationship determines whether an activity is market-making-related, not the characteristics of the parties to the transaction.
- Presently, the proposed rule does not properly accommodate important client-driven structured transactions. The final rule should recognize that these transactions are an important element of a banking entity's role and are related to its market-making activities.
- The proposed rule splits exemptions between the prohibition against proprietary trading and the prohibition against investing in covered funds in a manner that was not intended by the statute. As a result, we would be unable to engage in customer-driven underwriting and market making activity with respect to assets such as collateralized loan obligation equity and certain exchange-traded fund securities because such assets are treated as covered funds under the proposed rule.
- The agencies should not apply the final rule to commodity forward and foreign exchange products that clearly have a commercial, and not strictly financial, purpose.
- The proposed rule's proposed definition of "resident of the United States" would create competitive inequalities overseas among U.S. banking entities and should be amended to reflect the terms of the SEC's Regulation S so that the term "resident of the United States" does not include any agency or branch of a U.S. person located outside the United States

if the agency or branch operates for valid business reasons, is engaged in the business of banking and is subject to substantive banking regulation in the jurisdiction where located.

We have concerns about aspects of the proposed rule other than market-making that we believe would impair the ability of JPMorgan to provide its clients investment banking services. These concerns, all of which, again, we address in greater detail below, can be summarized as follows:

- Similar to our proposed treatment of the criteria for the market-making exemption, the proposed rule regarding risk-mitigating hedging should not rely on hard-coded criteria, but rather a number of the criteria should be addressed exclusively in an appendix where they would provide guidance that the agencies would apply to help distinguish permitted risk mitigating hedging activities from prohibited proprietary trading.
- The final rule should clearly permit banking entities to continue to use all risk management tools currently available to them, including scenario hedges. The proposed rule should be revised to make clear that scenario hedges are within the scope of the hedging permitted activity.
- The proposed rule does not clarify the status of intra-group trading activity – which firms frequently use for a variety of risk management, legal, tax and regulatory reasons – and therefore leaves unclear whether it is permissible. The final rule should take proper account of intra-group transactions by considering the economic effect of series of related transactions, not just individual transactions, on a banking entity group as a whole.
- The documentation burden associated with Section \_\_.5(c) of the proposed rule is unnecessarily disruptive. It should be applied at a less granular level and should not be applied to trading desks that exist to hedge risks assumed by other trading desks.
- The definition of covered fund set out in the proposed rule could cause the disappearance of certain securitization activities, resulting in a material reduction in credit for a wide range of industrial, commercial and service-sector entities. As drafted, we believe the definition exceeds the requirements of the statute and fails to take proper account of the FSOC's recommendations and the rule of construction set out in Section 13(g)(2) of the statute.
- The government obligations permitted activity should be expanded to include derivatives referencing government obligations because a failure to do so will inadvertently affect liquidity in government obligations themselves. In order to preserve liquidity in the bonds issued by other sovereign entities, it should also be expanded to include trading that is otherwise permitted by law in the obligations of all foreign governments that are comparable in credit quality to the United States.
- The definition of trading account should be limited to a purpose test as required by the statute. The presumption that any account used to acquire or take a covered financial

position that is held for sixty days or less is a trading account position exceeds congressional intent and should be removed from the final rule.

- The agencies should give further consideration to the meaning of the term “loan.” At present, it throws into question the treatment of certain market-standard means of transferring the risk associated with loans. We believe that there clearly are circumstances under which debt securities should be considered to be within the phrase “extension of credit” in the definition of loan and that the rule should leave room for the issue to be addressed on a case-by-case basis.
- The exclusion for repurchase agreements should be extended to encompass all transactions that are analogous to extensions of credit and are not based on expected or anticipated movements in asset prices.

## A. Market Making

### 1. The Essence of Market Making

The essence of a market maker’s job is to provide liquidity by quoting prices to customers and then to respond intelligently to the risks acquired when customers act on the quoted prices. A single trade will typically expose the market maker to multiple risks, and the successful market maker is one who makes the right choices about which risks to prioritize addressing, in what sequence, and with which instruments. The optimal choices are the ones that minimize the volatility of his or her portfolio while maximizing the amount of bid-offer spread captured over time. Market making thus necessarily involves risk mitigation rather than risk elimination. The proposed rule introduces significant uncertainty into this optimization process and risks diminishing the willingness of market makers to provide liquidity.

Regulated banking entities and broker-dealers are by far the largest providers of market-making-related services. The existence of a robust, competitive field of banking entities willing to provide liquidity is essential to creating secondary market support for investments like corporate and municipal bonds. Without the predictable source of secondary market liquidity that market makers provide, the risks of bond ownership would increase, causing investors to raise borrowing costs to issuers. That, in turn, would seriously impair capital formation.

In essence, the distinction between prohibited proprietary trading and the core capital-raising functions of the U.S. financial markets now rests on the agencies’ interpretation of the words “designed,” “reasonably expected,” and “near term.” Given the vital importance of the distinction, the choices that regulators make in implementing the statute are critical. While the proposed rule represents a good faith effort to resolve the uncertainty generated by the statute, its approach to supervision could reduce the willingness of firms to make markets. As we note in the introduction, in its directions to the FSOC, the statute clearly identified the promotion of safety and soundness as one of its primary objectives. At the same time, it

specifically recognized that some market-making-related activities were not in conflict with this objective and should be protected. The proposed rule instead focuses heavily on the possibility of firms “hiding” prohibited behavior or mischaracterizing activities to evade the statute and is insufficiently focused on the safety and soundness of firms and the financial markets more broadly. What follows in this section of the letter is a discussion of the principal issues that we believe should be addressed in order to minimize the adverse effects of the proposal on market-making-related activities.

## 2. Liquidity Substitution and the Shadow Banking System

A few observers have suggested that, while the statute may reduce the ability of banking entities to provide liquidity, that effect may be offset by an increase in market participation by non-regulated firms. We believe this argument is misplaced for two reasons. First, the statute provides a clear exemption for market-making activities by banking entities rather than directing the agencies to consider alternative providers of that service. Second, and more fundamentally, market realities make it highly unlikely that non-regulated entities would have the incentive or resources to serve as dependable market makers at narrow spreads, particularly in volatile markets when such services are most necessary. Such a suggestion ignores lessons from recent financial crises and greatly underestimates the importance of housing critical financial services within the regulated banking sector.

One important lesson is that procyclical liquidity is not a substitute for through-the-cycle liquidity. We view our market-making business as part of an overall franchise that includes commercial banking, lending and underwriting relationships. High-frequency traders and hedge funds play an important role in financial markets, but their business models do not require the development or maintenance of such relationships. As such, we believe that their willingness and ability to accept risk to support clients during periods of market stress (when, as we note above, a market maker’s services are of the greatest value) will naturally be more limited than those of a banking entity.

Market making is optimally located within financial institutions that are subject to close prudential supervision. The minimum capital requirements to which banking entities are subject ensure that, even in stressed markets, they have sufficient capital to participate actively in market making. Also, banking entities typically have access to diversified sources of funding that allow them to assume less liquid and more volatile positions from clients with greater confidence. By contrast, non-regulated financial market participants are typically very thinly capitalized and have limited, if any, access to traditional capital markets. Furthermore, managing the complexity associated with large portfolios of lightly mismatched “leftover” risk over long periods of time and in all market conditions, which is a critical element of a market-maker’s role, requires access to capital and risk management infrastructure that is only found in banking entities. As events like the collapse of Long Term Capital Management and others have demonstrated, market events like unexpectedly high margin calls threaten the viability of highly leveraged or lightly capitalized market actors with complex portfolios of offsetting positions.

Also, many non-regulated entities operate a business model that depends on executing a high volume of intra-day transactions and ending the trading day without any risk position at all. Even a small increase in execution uncertainty or operational risk can lead such an entity to exit a market. The “flash crash” of May 6, 2010 clearly demonstrates the destabilizing effect of such contingent liquidity.

We expect that, however it may be implemented, the statute will reduce liquidity. That impact will lead to a widening of bid-offer spreads that will attract non-regulated entities, at least temporarily. But we encourage the agencies to recognize that the business model of non-regulated entities means that any commitment to providing liquidity is likely to prove limited, high in cost, and fickle.

### 3. The Definition of Trading Account

As noted above, the proposed definition of trading account is broader than the statutory definition.

In a later section, we describe how the proposed market risk capital test would expand the statute to cover asset-liability management functions that should be permissible, and why it should be eliminated. Here we focus on three additional issues: (1) why the registration test should also be eliminated; (2) why the 60-day presumption is counterfactual and should be eliminated; and (3) how, in one way, the proposed rule expands the purpose test unwisely.

#### *Registration Test*

The inclusion of the registration test in the final rule would create significant uncertainty about the scope of the proprietary trading prohibition. The test appears to overlap entirely with the purpose test and, as such, is redundant. Further, the final rule will apply globally. In the course of preparing for the implementation of the final rule, it is becoming clear that, in certain jurisdictions, it is difficult to conclude with certainty whether frequent long-term investing activity gives rise to a local dealer registration requirement. In cases where it does, the registration test would make activity that lacks short-term trading intent subject to the statute’s prohibitions. Since that would exceed Congressional intent, the registration test should be removed from the proposed rule completely.

#### *Presumption*

Although it is described in the proposed rule as being intended to “simplify” and to provide “greater clarity and guidance,” the rebuttable presumption set out in the proposed rule that any covered financial position held for sixty days or less is a trading account position<sup>13</sup> (the “sixty-day presumption”) is an expansion of the proprietary trading prohibition set out in the statute. Nothing in the statute requires or implies a requirement for such a rebuttable

---

<sup>13</sup> See proposed rule Section \_\_.3(b)(2)(ii).

presumption and there should be no such presumption in the final rule. The sixty-day presumption only increases the uncertainty surrounding the proprietary trading prohibition. It is far from clear what evidence would suffice to rebut the presumption. Also, the inclusion of the sixty-day presumption highlights confusing inconsistencies in the agencies' approach to the definition of trading account. In relation to the market risk rules test, when looking for guidance with respect to the phrase "short-term," the proposed rule refers to the FASB ASC Master Glossary definition of "trading" which notes that "near-term" for purposes of classifying trading activities is "generally measured in hours and days rather than months or years." We find that inconsistent with a rebuttable presumption that a position held for two months was acquired with short-term trading intent. The proposed rule itself, at footnote 102, also appears to note the inconsistency.<sup>14</sup>

#### *Purpose Test*

While we generally support reverting to the statutory purpose test as the sole definition of trading account, we are concerned about the statement that a trading account "would also include a derivative, commodity future, or other position that, regardless of the term of that position, is subject to the exchange of short-term variation margin through which the banking entity intends to benefit from short-term price movements."<sup>15</sup> Decisions about the intervals at which collateral should be taken from counterparties are taken by credit risk managers, not traders. They reflect credit risk appetite, not trading intent. Regularly taking collateral to mitigate the credit risk associated with a financial transaction simply is not an indicator of short-term trading intent, and the statement should be deleted. It should be noted that Title VII of the Dodd-Frank Act will require certain firms to take collateral from their counterparties on a daily basis in respect of swap and security-based swap transactions whether or not they actually want to do so. Since that collateral posting is mandatory, it says nothing at all about intent. If left in the final rule, the statement may cause banking entities to alter otherwise prudent risk management practices to conform to the final rule. That would run contrary to the stated purpose of the statute and constitute a clear case of the cost of a rule outweighing its benefit.

#### 4. The Proposed Rule Should Not Rely on Hard-Coded Criteria

Because of its multiple overlapping parts, the proposed rule does not provide regulated entities a clear path towards compliance. For market making to continue in its current form,

---

<sup>14</sup> See proposed rule at footnote 102: "See FASB ASC Master Glossary definition of "trading." Although § .3(b)(2)(ii) of the proposed rule includes a rebuttable presumption that an account used to acquire or take certain covered financial positions that are held for 60 days or less is a trading account, the agencies note that U.S. GAAP does not include a presumption that securities sold within 60 days of acquisition were held for the purpose of selling them in the near term."

<sup>15</sup> See proposed rule at page 68858. The purpose test also includes covered financial positions acquired or taken principally for the purpose of benefitting from actual or expected short-term price movements.

as the statute clearly intended, firms should have a way of knowing whether the activities they are conducting will or will not qualify for the exception.

For example, Section \_\_.4(b)(2)(vi) of the proposed rule requires firms to conduct their market making-related activities in a manner consistent with Appendix B to the proposed rule. However, Appendix B provides that consistency with Appendix B is insufficient and also requires compliance with all of Section \_\_.4(b). In places, Appendix B and Section \_\_.4(b) address the same topic, and it is unclear whether compliance with Appendix B also constitutes compliance with the corresponding criterion in Section 4(b). If it does, it is difficult to see why there is a separate criterion in Section \_\_.4(b) at all. If it does not, it is unclear what additional compliance steps are required. Addressing the subject matter of Section \_\_.4(b)(2)(ii), (iii), (iv), (v) and (vii) of the proposed rule only in Appendix B would resolve the confusion that presently exists in the architecture.

The proposed rule proposes to apply seventeen metrics daily at a variety of points in the firm's trading hierarchy. Also, Appendix B to the proposed rule is a multi-page description of the distinctions between permitted market-making-related activities and prohibited proprietary trading that notes frequently how facts and circumstances can cause a genuine market-making business to resemble a proprietary trading business. Because of its use of hard-coded criteria in the proposed rule itself, as the proposed rule is presently constructed, a trading desk that has all of the anatomical properties of a market-making business,<sup>16</sup> that consistently yields satisfactory results with respect to the preponderance of the seventeen metrics and that operates its business consistent with Appendix B can still be told that its activities are prohibited proprietary trading because, for example, it held itself out on a regular basis when it should have held itself out on a continuous basis. That is clearly the wrong result and would be avoided if the subject matter of Section \_\_.4(b)(2)(ii), (iii), (iv), (v) and (vii) of the proposed rule were addressed only in Appendix B. That would allow the agencies greater flexibility as it would ensure that "facts and circumstances" can be factored into regulatory decisions. In a rule intended to address a variety of products and all market conditions, that flexibility is essential to proper supervision.

##### 5. The Proposed Rule Goes beyond the Statute to Proscribe "Market-Making Related" Activities

The statute very clearly permits the purchase, sale, acquisition or disposition of securities and other instruments in connection with market-making-*related* activities. As the agencies are aware, the word "related" was specifically added during the House-Senate conference process. In places, however, the proposed rule appears to read this word out of the statute. For example, the proposed rule states:

---

<sup>16</sup> For example, the business employs sales staff that cover clients, issues research to clients, delivers pricing runs to clients and is considered by the Street and by clients to be a market-making business.

a trading desk or other organizational unit of a banking entity that is engaged wholly or principally in arbitrage trading with non-customers would not meet the terms of the proposed rule's market making exemption.<sup>17</sup>

While some types of arbitrage trading might properly be considered speculative, others clearly relate to customer needs and should be seen as a part of a firm's market-making-related activities. Corporate bond exchange-traded funds provide a useful example of the latter. Exchange-traded funds are a low-cost means by which investors, often individuals, are able to participate efficiently in markets that would otherwise be closed to them. For the product to work, two conditions must be met: the underlying bonds must be tradable and liquid, and market participants must be willing to execute arbitrage transactions between the exchange-traded fund and the underlying bonds. The corporate bond exchange-traded fund market could not continue to function as it does without that arbitrage activity: supply and demand forces would cause the exchange-traded fund to diverge from fair value and distort its performance. The liquidity on the underlying bonds is provided by corporate bond market makers. For an exchange-traded fund market-maker, the ability to optimize various sources of liquidity, including the underlying corporate bond market, is an important factor in the efficiency that drives the exchange-traded fund's low friction costs. But the exchange-traded fund market-maker's portfolio construct might at times have the appearance of an arbitrage strategy. Often, as a matter of organizational efficiency, firms will restrict that strategy to certain specific individual traders within the market-making organization, who may sometimes be referred to as a "desk." The proposed rule apparently would not allow such a desk to rely on the market-making-related exception. We believe that this is inconsistent with the statute and unwise as a matter of policy.

Also, in order to minimize risk management costs, firms commonly organize their market-making activities so that risks delivered to client-facing desks are aggregated and passed by means of internal transactions to a single utility desk. The aggregated client-delivered risk is then hedged in aggregate and, optically, can bear some of the characteristics of arbitrage. Such activity is a direct function of a firm's market-making operations, and we encourage the agencies to recognize it as permitted market-making-related behavior.

## 6. The Proposed Rule Creates Considerable Doubt about the Status of Interdealer Trading Activity

Interdealer trading is a vital component of market making, as permitted under the statute. Accordingly, we suggest the agencies clarify that the nature of the trading relationship determines whether an activity is market-making-related, not the characteristics of the parties to the transaction.

In its discussion of the Customer-Facing Trade Ratio, the proposed rule notes that:

---

<sup>17</sup> See proposed rule at page 68871.

A broker-dealer, swap dealer, or security-based swap dealer, any other entity engaged in market making-related activities, or any affiliate thereof may be considered a customer of the trading unit for these purposes if the covered banking entity treats that entity as a customer...<sup>18</sup>

We regard that comment as a recognition of the important fact that there is a significant amount of interdealer trading activity where one dealer is acting as the customer of another. We also agree with the direction of the following comment made in the proposed rule:

activities by...a person that primarily takes liquidity on an organized trading facility or exchange, rather than provides liquidity, would not qualify for the market-making exemption under the proposed rule...<sup>19</sup>

Whether or not conducted on an organized trading facility or exchange, trading activity that has as its primary driver the provision of liquidity is market-making-related activity and should be permitted. We see no distinction in this regard between anonymous exchange-traded transactions and over-the-counter transactions where the identity of the counterparties is disclosed.

A particularly vivid example of why the agencies should clarify the status of interdealer activity is the direct market in currency options. The market is called “direct” because it is entirely bilateral and is neither intermediated by inter-dealer brokers nor executed on any organized trading facility. The currency options market is a global, 24-hour, 6-day-per-week market. Following the decades-old conventions of the foreign exchange spot market, firms provide two-way prices to each other in that market on demand. This informal agreement to quote two-sided prices to other market makers is an essential feature of being a market maker in the global currency options market. When one market maker provides pricing to another in that market, it considers the market maker to which it provides the pricing to be a customer. Access to that interdealer liquidity is essential to allow firms to develop the risk inventory needed to satisfy demand in their market-making franchises and to manage risks delivered to them by their non-dealer customers. At present, there is considerable confusion in the industry about whether the agencies view this activity as prohibited. We strongly recommend that the agencies clear up that confusion in the final rule.

## 7. The Proposed Rule Undervalues the Metrics

The proposed rule notes consistently that the metrics are designed for “identifying trading activity that warrants additional scrutiny.” They are equally well designed for identifying trading activity that warrants no further scrutiny. While we agree that no single metric can serve as a dispositive tool for identifying prohibited proprietary trading, we submit that if a business routinely passes over a dozen metric tests designed to determine whether it is a

---

<sup>18</sup> Proposed rule at page 68960.

<sup>19</sup> Proposed rule at page 68872.

market-making business, the need for further inquiry into the nature of the business is significantly reduced and may be superfluous. The final rule should provide that where a firm has established an internal compliance program with respect to a business and the metrics that are run by the firm demonstrate that the business is a market-making business, the business should benefit from a rebuttable presumption that it is in compliance with the final rule.

#### 8. The Metrics Require Changes to Reduce Impact on Liquidity and Decrease Implementation Burden

*Level of Reporting.* The proposed rule requires banking entities to calculate and report metrics at points in the organizational hierarchy down to the trading desk level. The choice of level at which to apply metrics is an extremely important one: while too high a level may cause smoothing of results, too low a level will routinely generate false positives. The opportunity to explain the facts and circumstances surrounding false positive mitigates the harm, but not enough: knowing that individual decisions will require explanation will seriously chill desirable capital commitment by market makers. That chilling effect will be magnified at the worst possible times since the incidence of false positives will increase in distressed market conditions, when a market maker's services are of the greatest value.

The proposed rule could safely be less granular and still be effective. At JPMorgan, the most senior level of trading risk management is referred to as the Investment Bank Risk Committee, or IBRC, and meets weekly to discuss the Firm's trading risks. The heads of all the trading businesses are represented at these meetings, and positions are discussed at a level of granularity that appropriately reflects the materiality of the risk. We believe that the metrics should not be applied below the level at which data is routinely reviewed by senior management at these IBRC meetings. For example, at JPMorgan, the trading business level would be Credit Trading or Institutional Equity as opposed to a sub-level within each business – e.g., North American Credit Trading.

*Frequency of Reporting.* The proposed rule proposes monthly reporting of metrics. While the agencies should retain the ability to request more frequent reporting on an exception basis and firms should be required to investigate anomalies as they arise, the routine reporting frequency should be quarterly. Monthly reporting is too frequent because of the complexity of the process that surrounds the generation of regulatory reports. Before such reports are submitted to regulators, they are subjected to trader, compliance, risk-manager and senior management reviews. That process is time consuming and, as a result, such reports are generally produced only on a quarterly basis.

*Calculation periods.* Similarly, thirty-day and sixty-day calculation periods are too short for some of the proposed measurements. A thirty-day calculation period will typically capture only 22 trading days. For statistical calculations, a sample set of 22 data points is just too small and creates an unnecessarily high degree of measurement uncertainty. To maximize their usefulness, the calculation period should be one calendar quarter (typically 63 trading days) for each of the following proposed quantitative measurements:

- Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss;
- Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio;
- Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss; and
- Spread Profit and Loss.

*Utility of the Metrics.* Some of the metrics are completely new; they are not currently in widespread use in the industry. Two metrics in this category are Inventory Risk Turnover and Spread Profit and Loss. While each is potentially useful in concept, the proposed implementation set out in the proposed rule is dramatically more difficult than necessary and will yield negligibly more insight than a less burdensome version of the test.

The Inventory Risk Turnover metric should focus only on the principal measure of directional risk for the subject portfolio. One of the core functions of a market-maker is to warehouse certain secondary risks, which is essential to the proper functioning of most markets. The purpose of an inventory turnover measure is to compare the amount of risk that a market maker retains to the size of the market marker's client franchise. A typical securities trading desk will trade many securities, and many desks will trade both derivatives and securities. The proposed rule's proposal to require firms to compute risk turnover in relation to *all* of the regularly produced risk sensitivities of *all* instruments within the relevant portfolio would require risk turnover to be calculated for ten or more risk sensitivities in some businesses and is excessive.

We believe that focusing only on the principal measure of directional risk strikes the right balance between practicality and relevance. Any concern that focusing only on that principal measure will encourage the warehousing of outsize positions in other risks should be mitigated by the application of other measurements (especially profit and loss volatility metrics and the Comprehensive Profit and Loss Attribution metric) that should effectively identify other risk concentrations. In addition, the more exotic the risk, the greater the difference in measurement methodology across firms. Requiring inventory risk turnover to be measured against more than the principal measure of directional risk will make it far more challenging for the agencies to manage horizontal reviews and, as such, to maintain a level playing field among firms.

With respect to the Spread Profit and Loss metric, the End of Day Spread Proxy is sufficient and should be used for all asset classes. Using the prevailing bid-ask or similar spread at the time the purchase or sale is completed is far more onerous than is necessary to distinguish position-related revenue from spread-related revenue. It will yield meaningless results in institutional markets where clients have significant bargaining power (which describes most markets for the institutions most affected by the statute) because, in those markets, it would be

perfectly reasonable for a firm to record the most recently traded price as the midmarket price. In that situation, the Spread Profit and Loss would be zero, producing a metric “failure” in all cases.

The End of Day Spread Proxy relies on processes that firms generally already have in place in response to industry-wide demand for accurate end-of-day valuations. It is much more objective than the proposed approach because it is subject to far greater scrutiny by third parties. Correctly, the proposed rule notes the need for market makers to manage retained principal risk effectively. Balancing risk in order to be able to quote to clients is an essential element of a trading business that is designed to satisfy near term customer demand. For the most liquid asset classes, the proposed approach will cause market makers who successfully manage intra-day fluctuations in client demand to appear to be trading with “a simple expectation of future price appreciation,”<sup>20</sup> leading to defensive pricing behavior and a reduction in market liquidity. While it could be argued that our proposed approach would allow a proprietary trading desk with an intra-day trading mandate to appear to have only spread-related revenue,<sup>21</sup> any such business would fail a simple review of its mandate and set-up and would almost certainly produce profit and loss volatility numbers inconsistent with a market-making business.

With respect to the Customer-Facing Trade Ratio, we believe that the metric should not be based on trade counting; instead it should be a risk-based normalization, similar to the Inventory Risk Turnover metric. The proposed approach introduces the possibility of nonsensical results. For example, a corporate customer might execute a multi-billion dollar hedge of its foreign currency exposure by buying a foreign currency put option in the FX Options market. The market-maker may, among other approaches, “call out” in the interbank market and exit the position in much smaller pieces. The result would be to have one customer trade and, perhaps, ten or more dealer trades, simply because each of the interbank trades is smaller.

Further, as the agencies acknowledge,<sup>22</sup> Stress VaR is not in regular use for day-to-day risk management. For Basel purposes, Stress VaR will be calculated only at the highest level of the firm, and computing it at a more granular level creates a significant implementation burden as well as problems in terms of comparability and relevance of results. More importantly, as a measure that conveys no information about intent or proportionality between the risk assumed and client demands, it provides little relevant information about a banking

---

<sup>20</sup> See proposed rule at page 68871.

<sup>21</sup> If a proprietary trading business had an intra-day trading mandate it would always end the trading day with a flat position. If the mid-market value of its trades were only determined at end of day then all of the revenue would go into the spread category, creating the appearance of compliance even though the activity is clearly prohibited.

<sup>22</sup> See proposed rule at 68887.

entity's compliance with the statute. We therefore believe that Stress VaR should be removed from the list of required metrics.

#### *Inapplicability to Asset-Liability Management*

The metrics proposed would not, in any form, be useful in distinguishing valid asset-liability management from proprietary trading. We discuss this in detail below, under "Asset-Liability Management."

#### 9. Solution-Driven Transactions

We are concerned that, generally, the proposed rule does not appear to acknowledge the more structured, client-driven transactions that banking entities routinely enter into with their client base. Such transactions (which are often referred to as "solution" transactions) are increasingly driven by client financing needs, but may also be driven by risk management considerations. For example, a transaction may be designed to provide a predictable source of funding for a client's regulatory capital needs or to provide structured protection to a client on its loan or securities portfolios. Our goal is either to give the client indirect access to cheaper sources of funding or assume risks from the client that we then distribute to the market.

Typically, the client-facing transaction is relatively structured and we hedge or offset the risk assumed using a combination of transactions executed through our market-making desks. This activity is related to our market-making franchises and therefore permissible under the statute.

Banking entities are by far the largest provider of these solution-driven products. We are concerned that the trading on behalf of customers permitted activity is not sufficiently broad to permit this activity and that a narrow interpretation of the requirement to hold oneself out "on a regular or continuous basis" would preclude reliance on the market-making permitted activity in connection with these client-driven transactions. We suggest the agencies make clear in the final rule that, for this purpose, a banking entity meets a requirement to hold itself out if it markets structured transactions to its client base and stands ready to enter into such transactions with them even though transactions may occur on a relatively infrequent basis.

#### **B. Risk-Mitigating Hedging Permitted Activity**

We discuss in detail below the application of the exception for risk-mitigating hedging to JPMorgan's corporate asset-liability management function. It is within that function, rather than within our investment bank, that we hedge the structural risks of the company's balance sheet. In this section, we discuss how the risk-mitigating hedging exception applies to hedging within our investment bank. As the proposed rule acknowledges, hedging is a vital part of market making, because it allows market makers to manage the principal risk they must incur to perform the function. In several ways, the proposed rule would make hedging more difficult.

## 1. The Proposed Rule Should Not Rely on Hard-Coded Criteria

The criteria in Section \_\_.5(b) of the proposed rule should be factors to be considered when distinguishing prohibited proprietary trading from hedging, not tests that must be satisfied in every case in order to qualify for the hedging permitted activity. For example, we are concerned that even if all other requirements of the hedging section are satisfied, a transaction is not a hedge unless it is contemplated by the written policies established by the firm pursuant to subpart D. That limits the ability of the firm to hedge unanticipated risks quickly.

The hedging permitted activity set out in the proposed rule is much narrower than the discussion of the hedging permitted activity in the preamble. For example, the preamble states that anticipatory hedging is permitted in certain circumstances but the text of the proposed rule itself makes no reference to anticipatory hedging.<sup>23</sup> The mismatch between the discussion in the preamble and the hard-coded criteria in the proposed rule generates considerable uncertainty. Removing hard-coded criteria from the proposed rule would help to resolve that uncertainty.

If the criteria in Section \_\_.5(b) in the hedging section of the proposed rule were removed and the subject matter of those provisions were addressed instead in an appendix to the proposed rule analogous to Appendix B, the agencies would be able to take facts and circumstances into account throughout the supervisory process. As we note above, we believe that is essential to the proper supervision of complex financial markets.

## 2. The Importance of Scenario Hedging

While most risk management is designed to address reasonably foreseeable risks, risk managers also routinely consider so-called “tail risks,” remote, but potentially devastating movements in a portfolio of assets that can follow events like the collapse of a major financial institution or the insolvency of a highly leveraged sovereign entity. As the agencies are aware, banking entities routinely stress test their balance sheets against such outlying scenarios and many banking entities are currently engaged in stress tests concerning macroeconomic and financial market scenarios mandated by the Federal Reserve to ensure that institutions have robust, forward-looking capital planning processes.<sup>24</sup> Typically, scenario hedges are not dictated by individual trading desks.<sup>25</sup> In fact, it is common for

---

<sup>23</sup> See page 68875 of the proposed rule and contrast it with Section \_\_.5(b)(2)(ii) of the proposed rule.

<sup>24</sup> See Federal Reserve press release November 22, 2011 at <http://www.federalreserve.gov/newsevents/press/bcreg/20111122a.htm>.

<sup>25</sup> Since most scenario hedges are established at higher levels of organization within banking entities, they would be subject to the additional documentation requirements set out in Section \_\_.5(c) of the proposed rule. Also, scenario hedges have a clearly identifiable risk and profit-and-loss profile. They should be identifiable using Value-at-Risk and Stress VaR and VaR Exceedance and revenue metrics. Consequently, supervisors will have ample opportunity to require banking entities to explain the facts and circumstances surrounding these trades.

individual trading desks to be unaware that such hedges have been established because awareness might change behavior in a manner that undermines the value of the hedge.

A position should qualify as a hedge if it is reasonably correlated to a specific risk or the banking entity can reasonably demonstrate through its stress testing program that the position reduces its tail risks. At inception, the correlation between a chosen hedge and a given tail risk may be relatively loose. Section \_\_\_.5(b)(2)(iii) of the proposed rule requires that the hedging transaction be “reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate.” We believe that this requirement may be too narrow to permit scenario hedging and, as such, could deprive banking entities of an important risk management tool.<sup>26</sup>

### 3. Intra-group activity

Generally, the proposed rule does not adequately discuss intra-group trading activity and therefore leaves unclear whether it is permissible. For a variety of risk management, legal, tax and regulatory reasons, banking entities frequently use booking vehicles that do not face external counterparties except to support the trading or hedging activities of other group members. For example, a hedge fund derivative transaction entered into by a U.S. banking entity with a non-U.S. customer may be hedged by means of an offsetting transaction between the banking entity and a non-U.S. affiliate of the banking entity that buys hedge fund shares as its hedge for the offsetting transaction. That combination of transactions provides the group, as a whole, with an efficient hedge to the customer-facing transaction. The proposed rule is drafted as though the same entity always executes both the risk-generating transaction and the hedge. The final rule should clearly allow banking entities to consider exempt groups of transactions entered into by different group members if they are connected and in aggregate act as a hedge for specific risks faced by one or more members of the group.<sup>27</sup>

### 4. Documentation of Macro Hedges

The proposed rule appears to underestimate the frequency with which hedges are established by a supervisor or risk manager responsible for more than one trading desk. We believe that the requirement for contemporaneous documentation should apply only to hedges executed one level or higher above the level described in the example contained in footnote 161 in the proposed rule. That is, the documentation requirement should apply only to hedges that are

---

<sup>26</sup> We also address these issues in the Asset-Liability Management section of this letter below.

<sup>27</sup> Another example of the proposed rule’s failure to recognize intra-group activity appears in relation to the market-making permitted activity. In many cases, mere booking entities are able to rely on intra-group exemptions under local law and do not carry dealer registrations. Since the proposed rule makes such registration an absolute condition, it would be impossible for such entities to rely on the market making exemption.

established by the manager of a person responsible for more than one desk or by more senior management. No additional documentation of a hedge transaction should be required at or below the level described in footnote 161 as long as the hedge in question is contemplated by the hedging policies and procedures maintained by the relevant business in compliance with Subpart D. Otherwise, the administrative burden associated with the proposed rule would be significant to the point of interrupting normal trading operations. That, in turn, may cause banking entities to become exposed to greater risks. It should also be noted that these hedges will be subject to testing using metrics and, as such, will be subject to review by the agencies.

The mandate of certain desks is to hedge the risks generated by other desks. Such risk management desks should not be subject to the documentation requirements with respect to their trading activity at all. We believe that it is incorrect to consider such desks to be “at a level of organization that is different than the level of organization establishing . . . the [risk generating transaction].” The two typically sit at the same level within an organization and typically have separate management reporting lines. If such desks were subject to the documentation requirements, their daily trading operations would be materially affected because they would be required to separately document the purpose of every trade executed. The final rule should make clear that such desks are not subject to the documentation requirements.

### **C. The Extraterritorial Application of the Volcker Rule Would Create Competitive Disadvantages among U.S. Firms**

The definition of “resident of the United States” contained in the proposed rule creates competitive inequalities among U.S. banking entities that operate overseas. As drafted, the proposed rule places U.S. banks that operate overseas through branches at a disadvantage to U.S. banking entities that operate overseas through subsidiaries. To avoid these inequalities, the definition of “resident of the United States” should be conformed to the definition of U.S. person contained in the SEC’s Regulation S.

Many U.S. banks conduct activities in covered financial positions from their overseas branches. Such activities are typically heavily regulated locally. For example, the London branch of JPMorgan Chase Bank, N.A. is a “resident of the United States.” It is regulated by the UK Financial Services Authority. However, a long-established U.K. subsidiary of a U.S. firm is not captured by any clause of the “resident of the United States” definition. As such, in their dealings with a branch, overseas entities must take into account the possible application of the Volcker Rule to their transactions, but, in their dealings with a subsidiary, they do not. Consequently, overseas entities are more likely to want to deal with subsidiaries than branches. We see no policy justification for the competitive disadvantage at which JPMorgan Chase Bank, N.A. would be placed – certainly no justification relating to the subject of the statute.

The inclusion of foreign branches of U.S. banks within the definition of “resident of the United States” in combination with the proposed rule’s definition of derivative, may adversely

impact trading in U.S. Government debt obligations by foreign investors in a manner that clearly was not intended by Congress. Although the Treasury Secretary has proposed to exclude foreign exchange swaps and forwards from regulation as swaps for most purposes<sup>28</sup>, the proposed rule proposes to include such products within the definition of derivative. Foreign exchange swaps and forwards are the means by which foreign investors convert local currencies into U.S. dollars so that they can purchase U.S. Government debt obligations. As such, liquidity in those products affects liquidity in U.S. Government debt obligations. Those products are very often executed with overseas branches of U.S. banks. If foreign exchange swaps and forwards remain covered financial products under the final rule and those overseas branches of U.S. banks are residents of the United States, then foreign investors will have to assess the proposed rule's implications when they trade in those products with such local branches. That, we believe, may reduce liquidity in those products and that, in turn, may reduce liquidity in U.S. Government debt obligations.

The agencies note that the definition of "resident of the United States" in the proposed rule is similar but not identical to the definition of U.S. person for purposes of the SEC's Regulation S. As it relates to bank branches, the definition should be identical. The full provisions of the U.S. person definition of Regulation S should be added to the proposed rule so that the term resident of the United States does not include any agency or branch of a U.S. person located outside the United States if:

- (i) the agency or branch operates for valid business reasons; and
- (ii) the agency or branch is engaged in the business of banking and is subject to substantive banking regulation in the jurisdiction where located.

#### **D. Government Obligations Permitted Activity**

We refer the agencies to the letter dated February 10, 2012 submitted by JPMorgan, Wells Fargo Bank, N.A., Deutsche Bank AG, New York Branch, RBC Capital Markets, LLC and Société Générale, New York Branch, in which we convey our concerns about the impact of the proposed rule on the market for municipal securities that do not fall within the scope of government obligations permitted activity and the impact of the proposed rule on the tender option bond markets. We believe that the government obligations permitted activity is also too narrow in certain other key respects. Our other principal concerns and recommendations can be summarized as follows:

- The permitted activity should be expanded to include derivatives referencing government obligations.

---

<sup>28</sup> See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25774 (May 5, 2011).

- The government obligations permitted activity should be expanded to include trading that is otherwise permitted by law in the obligations of all foreign governments that are comparable in credit quality to the United States.

Presently, the government obligations permitted activity addresses only direct holdings of government obligations. As a practical matter, it is rare for trading desks to trade only a cash instrument; trading desks that trade in government obligations routinely trade also in futures, options and swaps referencing government obligations. Subjecting trading in those instruments to the prohibitions of the statute could limit the ability of banking entities to position themselves efficiently and to hedge government obligations. That, in turn, would reduce trading in the government obligations themselves and, therefore, undermine Congressional intent with respect to the government obligations permitted activity. Since trading in futures, options and swaps on government obligations is essential to trading in the government obligations themselves, we believe that the agencies should exercise discretion under 13(d)(1)(J) of the statute to complete the government obligations permitted activity by extending it to such instruments.

As noted above, we share the concerns of certain foreign governments that the proposed rule would reduce liquidity in non-U.S. government bonds.<sup>29</sup> We believe that, as a matter of comity and in order to ensure that liquidity in foreign government securities is maintained, the government obligations permitted activity should be expanded to encompass the debt of all foreign governments that have a credit quality comparable to the U.S. At a minimum, the agencies should make clear that all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities are protected by the market-making-related permitted activity. Such activities may require a firm to assume positions in such debt securities even in circumstances where near-term demand is entirely unpredictable.

#### **E. Commodity Forwards Should Not be Included in the Final Rule.**

The statute does not expressly encompass forward contracts in nonfinancial commodities ("Commodity Forwards"). Certain agencies have noted that Commodity Forwards are commercial merchandising transactions, whose primary purpose is to transfer ownership of a commodity.<sup>30</sup> The Department of the Treasury has noted that they are more similar to funding instruments, such as repurchase agreements.<sup>31</sup> Although Commodity Forwards are

---

<sup>29</sup> See Letter from Chancellor of the Exchequer, George Osborne, to Chairman Bernanke, dated January 23, 2012 ("I am concerned that the regulations could have a significant adverse impact on sovereign debt markets . . .").

<sup>30</sup> See joint SEC and CFTC release "Further Definition of Swap, Security Based Swap, and Security Based Swap Agreement; Mixed Swaps; Security Based Swap Agreement Recordkeeping" (76 Fed. Reg. No. 99, May 23, 2011).

<sup>31</sup> See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25774 (May 5, 2011).

excluded from the definitions of the terms “swap” and “security-based swap” in the derivatives-related provision of the Dodd-Frank Act,<sup>32</sup> the agencies propose to exercise their discretion to expand the statute to encompass those instruments by including them within the Title VI definition of a “derivative.” We believe that there is ample evidence that commercial agreements such as Commodity Forwards should not be considered “financial instruments” as that term is used in Section (h)(4) of the statute and, as such, should not be made subject to the restrictions of the statute. However it may be implemented, the statute will, to some extent, impair liquidity in every asset class that it touches. This liquidity concern is made particularly acute by the lack of certainty currently surrounding the meaning of the term “spot” in relation to commodities where standard delivery periods can extend to weeks and perhaps even months. As we discuss further below, we have very similar concerns and comments with respect to the proposal to extend the reach of the statute to foreign exchange forwards and foreign exchange swaps. We strongly encourage the agencies to refrain from extending the statute to asset classes that are clearly commercial, as opposed to strictly financial, in nature.

## F. Loans

While we support the exclusion of loans from the proprietary trading prohibition and the other provisions of the proposed rule directed at protecting the loan markets, we believe that the proposed rule does not go far enough in certain respects. Our principal concerns can be summarized as follows:

- The final rule should make clear that the primary means of transferring interests in loans are not within the scope of the rule.
- We believe that there clearly are circumstances under which debt securities should be considered to be within the phrase “extension of credit” in the definition of loan and that the rule should leave room for the issue to be addressed on a case-by-case basis.
- The final rule should make clear that covered financial positions that are acquired by a firm as a result of a default under a debt previously contracted in good faith are not subject to the proprietary trading prohibition.
- The loan securitization exemption is too narrow to allow banking entities to acquire or retain an ownership interest in a typical loan securitization vehicle, a collateralized loan obligation. As such, they do not successfully implement the rule of construction under section 13(g)(2) of the statute.

The purchase and sale of loans are outside the scope of the proprietary trading prohibition. Assignments and participations are the principal means used by lenders to transfer interests in

---

<sup>32</sup> See section 721 (adding a new paragraph 47(B)(ii) to the Commodity Exchange Act).

loans (and commitments to make loans). A loan participation is a traditional banking product used as an alternative to an assignment, typically in circumstances where consent to an assignment is unavailable. A loan participation is a transfer or acquisition of a lender's economic interest in a loan that places the participant in the same risk position as an owner of a portion of the loan. However, although for many purposes (including accounting purposes) the originating banking entities and the participant treat the participation as a sale of the loan to the participant, the "lender of record" does not change. Given the nature and purpose of a loan participation we believe that the agencies intend to treat loan participations as a loan for purposes of Section \_\_.3(b)(3)(ii) of the proposed rule. We believe however that the following text in the proposed rule should be clarified to avoid any ambiguity on this point:

The reference in § \_\_.3(b)(3)(ii) to a position that is, rather than a position that is in, a loan...is intended to capture only the purchase and sale of these instruments themselves.

The proposed rule questions whether the definition of loan should exclude a security. We note below how such an exclusion would undermine the value of the loan securitization exemption. It would also cause disruption in markets where security-based products like variable funding notes are used in place of loans. Like repurchase agreements, while such products are legally distinguishable from loans, they operate in economic substance as loans, and are not based on expected or anticipated movements in asset prices. As with almost all of the subject matter of the proposed rule, a generalized approach to the meaning of the phrase "extension of credit" in the definition of loan would have unintended consequences. We encourage the agencies to use the initial conformance period to develop a comprehensive understanding of the policy and practical implications of a blanket exclusion of securities from that phrase and to work with the industry to develop an approach to the issue that accommodates both the breadth of the statute's proprietary trading prohibition and the need to preserve important sources of credit for U.S. and international businesses.

Despite the exclusion of loans, lending activity will be reduced by the statute unless the final rule excludes from the proprietary trading prohibition all covered financial positions acquired by a firm in the ordinary course of collecting a debt previously contracted. Without that exclusion, banking entities will be less willing to extend loans against collateral in the form of covered financial positions or to extend loans to distressed companies which may result in the lender receiving covered financial positions in lieu of the debt previously contracted in a bankruptcy proceeding. We note that the proposed rule proposes to apply such an exclusion to the prohibition on covered funds activities. We strongly support that proposal and believe that it clearly should be applied in respect of the proprietary trading prohibition as well.

The loan securitization exemption set out in Section \_\_.13(d) of the proposed rule (the "loan securitization exemption") does not reflect the terms of typical loan securitizations. Even the most typical loan securitization vehicles, collateralized loan obligations, will, from time to time, own assets other than those listed in the loan securitization exemption. For example,

subscription proceeds and proceeds from the repayment of loans are commonly held in high quality assets such as Treasury securities, highly rated commercial paper or U.S. dollar cash until such time as they are applied, for example, to acquire loans. Also, like firms, collateralized loan obligations may receive assets other than loans in the course of collecting a debt previously contracted in good faith. It should also be noted that almost no collateralized loan obligations owns credit exposure exclusively in the form of loans; virtually all of such securitizations also permit a holding of corporate bonds or of bonds issued by other collateralized loan obligations. Although they may represent a small percentage of the overall assets of the structure, such “bond buckets” are an essential element of the structure because they allow the structure to access credit assets at times when appropriate assets in the form of loans are temporarily unavailable. Collateralized loan obligations are an important part of the loan markets. There will be almost no occasion on which it will be possible for a banking entity to rely on the loan securitization exemption in relation to a collateralized loan obligation. Consequently, the loan securitization exemption does not (even partially) give effect to the rule of construction under section 13(g)(2) of the statute (the “securitization exclusion”)<sup>33</sup> in that respect. We recommend that the agencies revise the loan securitization exemption to reflect the terms of market-standard collateralized loan obligation transactions.

## **G. The Proposed Definition of Covered Funds Would Disrupt Certain Lending Activity**

We discuss in a separate section below several ways in which the definition of covered funds is overbroad with respect to our asset-management business, but note here additional issues that arise in the trading context. The proposed rule encompasses certain securitization vehicles and could result in the disappearance of a number of beneficial securitization activities altogether. That, in turn, would materially reduce the availability of credit for a wide range of industrial, commercial and service-sector entities. As drafted, we believe the definition exceeds the requirements of the statute and fails to take proper account of the securitization exclusion. The final rule should exempt securitization issuers that rely on the exemptions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, such as asset-backed commercial paper conduits (“ABCP Conduits”),<sup>34</sup> from the definition of covered fund.

---

<sup>33</sup> Which provides that nothing in the statute is to be “construed to limit or restrict the ability of a banking entity . . . to sell or securitize loans . . .”

<sup>34</sup> An ABCP Conduit is a special purpose entity, often established by a firm, which issues asset-backed commercial paper to fund such ABCP Conduit’s activities. ABCP Conduits provide financing to customers of the firm by providing secured loans to special purpose entities established by customers, or by purchasing asset-backed securities issued by special purpose entities established by customers. In order to facilitate the ABCP Conduit’s issuance of asset-backed commercial paper, the firm that establishes the ABCP Conduit provides liquidity facilities to the conduit to provide funds for the timely repayment of commercial paper, and frequently provides additional credit enhancement to the conduit, often in the form of a letter of credit. ABCP Conduits are prominent examples of securitization vehicles that would be considered “Covered Funds” under the proposed rule, because they typically rely on the exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

Firms are involved in securitization transactions in various capacities. In addition to securitizing their own loans, for example, they arrange and underwrite securitization transactions for their customers, provide liquidity facilities and credit enhancement to securitization vehicles, establish and administer vehicles such as ABCP Conduits to provide financing to their customers, and provide such financing directly to customers through the direct purchase of asset-backed securities. Certain securitizations are able to rely on exemptions from the Investment Company Act other than those contained in Sections 3(c)(1) and 3(c)(7) of that Act, but many securitizations, such as ABCP Conduits, would be investment companies but for those exemptions and, as such, would meet the definition of a covered fund under the proposed rule. Precluding banking entities from engaging in activities that have long been recognized as permissible activities for banking entities, and that are vital to the normal functioning of the securitization markets, will have an extremely significant and negative impact on the securitization markets and on the ability of banking entities and other companies to provide credit to their customers.

Because Congress understood the important role that securitization plays in the provision of credit to consumers and companies, it included the securitization exclusion in the statute. If the definition of covered fund set out in the proposed rule is adopted in the final rule then the final rule will restrict the ability of banking entities to sell or securitize loans and the final rule will not give effect to the securitization exclusion.

The proposed rule suggests that the agencies consider themselves bound by the statute to treat all entities that rely on the exemptions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act as hedge funds or private equity funds.<sup>35</sup> We believe that the agencies are not so bound and, in fact, could have defined hedge funds and private equity funds without reference to those exemptions at all. Under the statute, the terms hedge fund and private equity fund are defined to mean an issuer that would be an investment company under those exemptions *or* such similar funds as the agencies may, by rule, determine. The proposed rule suggests that the agencies interpreted an “*or*” in section (h)(2) of the statute as an “*and*,” resulting in the overly broad definition of covered fund contained in the proposed rule. We believe that the agencies have the statutory flexibility to adopt a definition of hedge fund and private equity fund that encompasses only those entities that are recognized in the market place as such and that excludes entities, such as securitization vehicles, that are clearly distinguishable from hedge funds and private equity funds. In fact, the securitization exclusion explicitly directed the agencies to avoid adopting rules that would limit or restrict the ability of banking entities to sell or securitize loans.

---

<sup>35</sup> See proposed rule at page 68897: “The proposed rule follows the scope of the statutory definition by covering an issuer only if it would be an investment company, as defined in the Investment Company Act, *but for* section 3(c)(1) or 3(c)(7) of that Act.”

As is true for collateralized loan obligations, the loan securitization exemption is too narrow to be of sufficient value in the broader securitization context as it applies only to issuers of asset-backed securities whose assets are solely composed of “loans” and certain other assets. This fails to recognize that securitization issuers commonly hold assets such as liquidity facilities, credit enhancement, and highly liquid investments or cash in their collection accounts. Notably, it also appears that the agencies are interpreting the definition of “loan” quite narrowly, as the preamble indicates that the agencies do not view that definition to include asset-backed securities. However, securitization vehicles routinely purchase asset-backed securities and other financial interests that have long been viewed by banking entities and the agencies as simply an alternative means by which banking entities provide financing to their customers.

The risk retention exemption also has been drafted too narrowly to be of use in implementing the securitization exclusion, as it limits the amount of a firm’s interest to the minimum risk retention requirements of new Section 15G of the Exchange Act and the rules adopted thereunder (the “Risk Retention Rules”). However, the Risk Retention Rules acknowledge that a securitizer may be required to maintain risk in excess of the minimum specified in those rules due to the demand of investors, other rules (including Article 122a of the European Union Capital Requirements Directive), or in order to avoid breaching the minimum risk retention rules due to fluctuations in the underlying asset pool.

Furthermore, even if an entity is able to rely on the loan securitization exemption or the risk retention exemption as they appear in the proposed rule, a firm that sponsors, manages or advises a securitization issuer would be prohibited by the so-called Super 23A provisions set out in Section 16 of the proposed rule from entering into “covered transactions” with that issuer. That would prevent many banking entities from providing the liquidity facilities and credit enhancement that investors in the asset-backed securities require. If such enhancements are not provided then the securitization simply is not viable. The end result of all of these provisions is that the sale and securitizations of loans will have been limited or restricted by the rules that give effect to the statute, contrary to the clear intent of the securitization exclusion.<sup>36</sup>

While we recognize that the agencies could retain the loan securitization exemption and the risk retention exemption and attempt to revise those exemptions to address concerns raised by participants in the securitization markets, we believe that it would be extremely difficult to modify those provisions in a way that would give full effect to the securitization exclusion. The FSOC Study clearly recommended that the agencies carefully evaluate the range of funds

---

<sup>36</sup> We note that we are not providing the agencies with an exhaustive list of all problems that the proposed rule poses to securitization vehicles, as we believe that the most efficient and effective way for the agencies to address these problems is to exclude securitization vehicles from the definition of covered fund. For a more complete list of securitization related issues, the agencies should refer to comment letters drafted by various industry groups, in particular, the comment letters submitted by the American Securitization Forum and SIFMA with respect to Volcker Rule provisions that impact securitization.

and other vehicles that rely on the exclusions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act.<sup>37</sup> We encourage the agencies to revisit the approach taken in the proposed rule to ensure that the approach taken in the final rule does not inadvertently limit the availability of credit by unnecessarily and inappropriately limiting the ability of banking entities to engage in securitization activities.

## H. Repurchase and Reverse Repurchase Agreements

We agree repurchase or reverse repurchase agreements should not be considered trading account instruments. We also agree with the statement that, in substance, such transactions operate much like a secured loan, and are not based on expected or anticipated movements in asset prices. However, we believe that the proposed rule should have gone further and extended the treatment given to repurchase and reverse repurchase agreements to all transactions that a firm can reasonably demonstrate are not based on expected or anticipated movements in asset prices and that, notwithstanding their legal characterization, operate in economic substance as a financing transaction.

Several types of transactions with legal characteristics that distinguish them from loans are analogous to extensions of credit and are not based on expected or anticipated movements in asset prices. Total rate of return swaps where the firm is fully hedged by holding the asset that is the subject of the swap is an example. In such trades, the economic interest of the firm is limited to the value of a financing leg that is typically a floating rate of interest plus a spread. A foreign exchange swap is a further example. As the Department of the Treasury noted in its proposed Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act<sup>38</sup> (the “proposed FX determination”) foreign exchange swaps are “predominantly used as short-term funding instruments similar to repurchase agreements”. Although the proposed FX determination treats them differently,<sup>39</sup> precisely the same can be said for currency swaps. Currency swaps are currently the primary source of U.S. dollar funding for European entities that fund naturally in euro but also have a need for U.S. dollars to fund their operations. Given the current economic crisis in Europe, many of such entities are unable to access the U.S. dollar-denominated commercial paper market and the currency swap market (also referred to in this context as the basis swap market) has become the funding source of last resort. Importantly, a determination that these

---

<sup>37</sup> See FSOC Study at page 62. We support comments being submitted by SIFMA regarding an exclusion for securitization vehicles from the definition of covered fund as well as a similar exclusion for other investment vehicles that might rely on the exemptions contained in Sections 3(c)(1) and 3(c)(7) but that are not in the nature of a hedge fund or private equity fund.

<sup>38</sup> See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25774 (May 5, 2011).

<sup>39</sup> Although the proposed FX determination treats them differently, foreign exchange swaps and currency swaps are not materially different in this respect. Both are, in essence, funding transactions. Currently, it is market practice to structure these funding transactions as currency swaps.

types of transactions are not subject to the Volcker Rule's prohibitions would not affect their status under, for example, the securities laws or the Commodity Exchange Act. Total rate of return swaps transactions and currency swap transactions would remain heavily regulated as security-based swaps and swaps, respectively. Foreign exchange swaps would remain subject to the CFTC's new trade-reporting requirements, enhanced anti-evasion authority, and strengthened business-conduct standards for swaps dealers and major swap participants.

## I. The Statute's Exceptions Apply to All Activities It Covers

We support the letter submitted by three law firms, which makes clear that all exceptions contained in the statute unambiguously apply to all types of conduct covered by the statute, whether it be trading or fund ownership.<sup>40</sup>

This point is important. For example, as we note above, many structured finance vehicles rely on the exemptions contained in sections 3(c)(1) and 3(c)(7) of the Investment Company Act and, as such, would be covered funds as that term is presently defined in the proposed rule. As the proposed rule is presently structured, the market-making permitted activity affords an exemption from the prohibition against proprietary trading, but affords no exemption from the prohibition against acquiring or retaining an ownership interest in covered funds. As a result, we would be unable to engage in customer-driven underwriting and market making activity with respect to assets such as collateralized loan obligation equity, European exchange-traded fund securities and securities issued by U.S.-exchange traded funds that are commodity pools.

## J. Compliance Program

We support the clear statements in the proposed rule permitting a banking entity to establish a compliance program on an enterprise-wide basis when practical.<sup>41</sup> We believe that coordination – and, when appropriate, consistency – across trading units will be essential to the effective and efficient implementation of a compliance program on this scale. As currently proposed, however, the non-metric aspects of the compliance program are too granular, would be unnecessarily duplicative, and would disrupt trading activities. The proposed rule should be revised to permit greater flexibility in the level of the organization at which certain policies and procedures are implemented. We see limited benefit to implementing and maintaining separate written policies and procedures for each trading unit, and believe that it will be counterproductive for policies and procedures to be so granular. Indeed, this manner of documentation and maintenance will likely reduce the clarity and

---

<sup>40</sup> See Memorandum from Cleary Gottlieb Steen & Hamilton, Davis Polk & Wardwell, and Sullivan & Cromwell, January 23, 2012.

<sup>41</sup> Unless specifically stated, our comments on the compliance requirements focus on the non-metric aspects of the enhanced program required under Section \_\_.20(c)(1) of the proposed rule.

accuracy of the message to traders, and increase the likelihood of unintended inconsistencies between the numerous, duplicative compliance framework documents.

More specifically, the proposed rule's inflexible requirement that certain policies and procedures exist for each trading unit will ultimately detract from banking entities' ability to maintain a coordinated, organization-wide compliance program for at least three reasons. First, our experience suggests that it is counterproductive to implement policies or procedures on such a granular level because it creates a false, and potentially hazardous, implication that the policies or procedures in question cover every possible scenario that may be encountered by a trading unit and therefore can be relied upon as an all-inclusive "checklist." Because no policy or procedure can anticipate or address every situation that may create an opportunity for misconduct, policies and procedures should be drafted with some level of generality to take account of the unexpected and ensure that traders consult with their internal compliance officers when fact-specific questions arise.

Second, the proposed rule's policy and procedure framework encourages box-checking for each trading unit, rather than internal compliance best practices that are refined and enhanced over time. If there is uniformity and consistency across trading units from a compliance perspective – as there will be among many closely-related trading units – those units would benefit from consolidated policies and procedures. This promotes, for example, trading units replicating lessons learned by one another in a developing compliance program. As long as they cover all employees in applicable trading units, the level at which these policies are implemented should be left to the discretion of the banking entity with those policies and procedures subject to ongoing review by the Board.

Finally, the proposed rule's requirement that policies and procedures be implemented on a trading unit level will broadly disrupt trading activities given the extensive work required of business management in documenting and maintaining policies that meaningfully reflect each trading unit's business and each trader's book. For this reason, the proposed rule's granular implementation and information requirements also threaten to conflate the distinct roles of business management and compliance in a manner that undermines the essential independence of the compliance function and detracts from the core mission of that function.

### **III. Funds and Asset Management Activities**

J.P. Morgan Asset Management ("JPMAM"), with assets under supervision of approximately \$1.9 trillion and assets under management of approximately \$1.3 trillion (as of December 31, 2011), is a global leader in investment management. JPMAM's customers include institutions, retail investors and high-net worth individuals in every major market throughout the world. JPMAM offers investment management services globally, including in equities, fixed income, real assets, alternatives and liquidity products.

Below, we highlight three significant concerns with the proposed rule: (1) the impact on our asset management business of the definitions of "covered fund" and "banking entity" as they

relate to JPMAM and other U.S. institutions' foreign funds and asset management activities outside the United States;<sup>42</sup> (2) the potential negative impact on corporate bonds held by our customers; and (3) limitations on the ability of banking entities, like JPMorgan, to continue to make investments through funds that are designed to promote the public welfare both in and outside the United States.<sup>43</sup>

## A. Foreign Funds

The Volcker Rule prohibits banking entities from acquiring or retaining an ownership interest in, or sponsoring, hedge funds or private equity funds. The Volcker Rule generally defines "hedge funds" and "private equity funds" as issuers that would be investment companies, as defined in the Investment Company Act of 1940 (the "Investment Company Act"),<sup>44</sup> but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act. The Volcker Rule on its face also permits the agencies, in their discretion, to designate as "covered funds" additional funds that are "similar" to "hedge funds" and "private equity funds" such that they would be covered by the Volcker Rule's limitations.<sup>45</sup> Pursuant to this authority, the agencies have expanded the definition of covered fund in the proposed rule to include "[a]ny issuer, as defined in section 2(a)(22) of the [Investment Company Act], that is organized or offered outside of the United States that would be a covered fund as defined in [Section \_\_.10(b)(1)(i), (ii) or (iv) of the proposed rule], were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States . . . ." (such provision, the "Foreign Funds Designation").<sup>46</sup>

### 1. Foreign Funds as "Covered Funds"

As currently drafted, the Foreign Funds Designation could be read to require banking entities to engage in two inquiries: first, were the foreign fund hypothetically organized in the United States, would it need to rely on Section 3(c)(1) or 3(c)(7) and second, were the foreign fund

---

<sup>42</sup> This section of our letter specifically addresses (i) Questions 224 and 225 in the preamble to the proposed rule requesting comment on whether entities are captured by the proposed definition of covered fund that do not appear to be appropriate and whether the designation of certain foreign funds under Section \_\_.10(b)(1)(iii) of the proposed rule correctly describes entities that should be "covered funds" and (ii) Question 8 in the preamble requesting comment on whether an express exclusion from the definition of "banking entity" should be made for mutual funds and other registered investment companies that are not structured as affiliates of banking entities for BHC Act purposes.

<sup>43</sup> This section of our letter specifically addresses Question 276 in the preamble to the proposed rule requesting comment on whether the proposed rule effectively implements the public welfare investment exemption under the Volcker Rule.

<sup>44</sup> 15 U.S.C. § 80a-1 *et seq.*

<sup>45</sup> 12 U.S.C. § 1851(h)(2).

<sup>46</sup> Section \_\_.10(b)(1)(iii) of the proposed rule.

hypothetically offered to U.S. residents, would it need to rely on Section 3(c)(1) or 3(c)(7). Under one plausible reading, an affirmative answer to either of these inquiries would result in the foreign fund being a “covered fund.” The first inquiry is problematic because it requires banking entities to analyze their foreign funds through the lens of the Investment Company Act. This is a potentially impossible inquiry because foreign funds, even regulated and publicly offered foreign funds, such as E.U.-based UCITS,<sup>47</sup> are structured to comply with their own home-country regulatory schemes that may not be consistent with the requirements of the Investment Company Act that would permit such funds to satisfy either the registration requirement under the Investment Company Act or a Investment Company Act registration exemption, other than Section 3(c)(1) or 3(c)(7). Even if a foreign fund theoretically were able to conclude that, if it were organized in the United States, it would not need to rely on Section 3(c)(1) or 3(c)(7), the second inquiry could be read to capture virtually all regulated and publicly offered foreign funds because the Investment Company Act prohibits a foreign-organized fund from making a public offering in the United States without the SEC’s approval.<sup>48</sup> Such a foreign fund, by administrative interpretation, is permitted to use the jurisdictional means of the United States to make an offering to U.S. residents only if it complies with the limitations set forth in Section 3(c)(1) or 3(c)(7), as if it were organized in the United States. Consequently, as currently drafted, the Foreign Funds Designation could be read to designate virtually all foreign funds, even regulated and publicly offered foreign funds, as covered funds.

## 2. Application to JPMAM; Statutory Definition; Intent of Congress; Intent of the Agencies

JPMAM offers registered mutual funds and other fund products in the United States as well as analogous funds outside the United States (such as UCITS). Indeed, JPMAM offers nearly 800 funds in Europe, Latin America and Asia, with nearly \$300 billion in assets under management, the great majority of which are funds that are similar to U.S. mutual funds. For example, JPMAM is the largest sponsor of Luxembourg-based UCITS, with approximately 300 funds and \$240 billion of assets under management, and the largest sponsor of U.K. investment trusts, with more than 22 funds and approximately \$10 billion of assets under management. Those two categories (UCITS and UK Investment Trusts) account for more than 80% of JPMAM’s assets under management in foreign funds. Revenues associated with those foreign fund operations are significant contributors to JPMAM’s overall success.

Under the Volcker Rule and the proposed rule, JPMAM’s U.S. mutual fund complex would not be covered by the Volcker Rule because those funds are registered pursuant to the Investment Company Act and, thus, are not within the definition of covered fund. However, as discussed above, virtually all of JPMAM’s publicly offered foreign funds that are subject to a non-U.S. regulatory scheme, including UCITS, are at risk of being deemed to be covered

---

<sup>47</sup> Undertaking for Collective Investment in Transferable Securities.

<sup>48</sup> 15 U.S.C. § 80a-7(d).

funds under one plausible reading of the proposed rule, notwithstanding that those foreign funds are, in many cases, mirror images of their counterparts in the United States, and are neither “similar” to funds that must rely on either Section 3(c)(1) or 3(c)(7) nor resemble traditional hedge funds or private equity funds. In light of this potential result and other considerations, JPMAM believes that, unless clarified, the proposed rule’s treatment of foreign funds is not consistent with the statute, Congressional intent<sup>49</sup> or the recommendations made by the FSOC on the Volcker Rule.<sup>50</sup>

It is clear from the statute that the agencies are authorized to expand the statutory definition of covered fund only to capture funds that are “similar” to hedge funds or private equity funds of the type described in Section \_\_.10(b)(1)(i) (*i.e.*, funds that, among other things, must rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act, and, therefore, by definition, cannot engage in a public offering). A similar fund, therefore, should be a fund that, at the very least, is both unregulated and privately placed. Hedge funds and private equity funds as commonly understood also typically do not provide frequent liquidity for investors (redemptions are often subject to lock-up periods and lengthy notice periods prior to redemption). Funds that provide for regular liquidity to investors, in our view, are not similar to traditional hedge funds and private equity funds. Given the nature of the statutory direction to cover only similar funds, we believe that the current treatment of foreign funds may not have been the result intended by the agencies in drafting the Foreign Funds Designation.

We believe that the agencies intended the Foreign Funds Designation to capture traditional hedge funds and private equity funds that are organized or offered outside the United States (and thus do not need to rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act).<sup>51</sup> Indeed, the preamble to the proposed rule states that the Foreign Funds Designation was “proposed to include as ‘similar funds’ . . . the foreign equivalent of any entity identified as a ‘covered fund’ . . . [because] they are generally managed and structured similar to a covered

---

<sup>49</sup> Congress intended to restrict banking entities from retaining ownership interests in traditional hedge funds and private equity funds (see Himes Frank Colloquy, 111 Cong. Rec. H5226 (daily ed. June 30, 2010) (statements of Reps. Himes and Frank)).

<sup>50</sup> The FSOC recommended that the agencies expand the coverage of the Volcker Rule to funds that “engage in the activities or have the characteristics of a traditional private equity fund or hedge fund.” See FSOC Study at 62 (emphasis added).

<sup>51</sup> Because the statutory text of the Volcker Rule relies on the Section 3(c)(1) and 3(c)(7) exemptions in the Investment Company Act to define “hedge funds” and “private equity funds,” funds that are not required (or able) to register under the Investment Company Act, because, for example, they are organized and offered outside the United States and do not use U.S. jurisdictional means, would appear not to be covered by the Volcker Rule even if those funds were the foreign equivalents of traditional hedge funds and private equity funds. Coverage of the Volcker Rule, in fact, should apply comparably to equivalent U.S. hedge funds and private equity funds and non-U.S. hedge funds and private equity funds. As discussed *infra*, we believe that in order to apply this principle of equivalent treatment, however, the definition of covered fund in the proposed rule needs to be modified.

fund . . .”<sup>52</sup> Although we agree that the definition of covered fund should include traditional hedge funds and private equity funds organized or offered outside the United States, the Foreign Funds Designation, as currently drafted, could be read to capture foreign funds that are not the “‘foreign equivalent’ of covered funds” and are not “managed and structured similar to a covered fund.” The Foreign Funds Designation should set forth clear and objective criteria that investment management firms, like JPMAM, can apply to their range of foreign funds to determine, with efficiency and certainty, whether any of their foreign funds are covered funds.

### 3. Recommendation

Capturing the foreign equivalents of hedge funds and private equity funds as commonly understood does not require the Foreign Funds Designation to be structured in the manner proposed.<sup>53</sup> The proposed draft of the Foreign Funds Designation could be corrected most simply by exempting from the definition of covered fund any foreign fund that is publicly offered because, as noted above, a publicly offered fund is not similar to a traditional hedge fund or private equity fund and could not, by definition, rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act if it were offered in the United States. In the event the agencies do not find this simple solution acceptable, JPMAM recommends that the agencies adopt a more tailored approach to the Foreign Funds Designation designed to capture hedge funds and private equity funds as commonly understood and to treat analogous U.S. and foreign funds similarly. Such an approach should allow JPMAM and other U.S. financial institutions to continue to offer regulated and publicly offered funds outside the United States, as they currently do, and to compete in this business with other international U.S. and non-U.S. asset management firms. Below, we have proposed a revision of the Foreign Funds Designation that, we believe, accomplishes this goal.

In order to implement the clear statutory language of the Volcker Rule and the intent of Congress, we believe Section \_.10(b)(1)(iii) of the proposed rule should be modified to read as follows:

“(iii) Any issuer, as defined in section 2(a)(22) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(22)), that satisfies each of the following conditions:

---

<sup>52</sup> See proposed rule at page 68897.

<sup>53</sup> As the agencies noted in the preamble to the proposed rule, Section II.A: “[A]ny rule must also preserve the ability of a banking entity...to effectively deliver its clients the types of financial services that section 13 expressly protects and permits. These client-oriented financial services, which include...traditional asset management services, are important to the U.S. financial markets and participants in those markets, and the agencies have endeavored to develop a proposed rule that does not unduly constrain banking entities in their efforts to safely provide such services” See proposed rule at page 68849.

- (A) The issuer is an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-3);
- (B) The issuer is organized outside the United States and ownership interests in the issuer are offered outside the United States;
- (C) If the issuer were organized in the United States but not registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*), and ownership interests in the issuer were offered in the United States, the issuer would not be able to rely on any exemption from registration other than Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(1) or (7));
- (D) The issuer cannot satisfy each of the following criteria:
  - (1) The issuer is registered pursuant to, or regulated under, the laws of a qualified jurisdiction;<sup>54</sup>
  - (2) Ownership interests in the issuer were sold in a public offering or series of related public offerings<sup>55</sup> in one or more qualified jurisdictions, or the issuer is being organized for the purpose of selling its ownership interests in a public offering or a series of related public offerings in one or more qualified jurisdictions, provided that no offering will be considered a “public offering” pursuant to this clause (2) if: (i) such offering could be made pursuant to Section 4(2) of the Securities Act of 1933 (15 U.S.C. 77D(2)) if it were conducted in the United States; or (ii) the ownership interests sold in such offering or series of related offerings are listed on one or more securities

---

<sup>54</sup> Section \_\_.2 of the proposed rule would be amended to include a new definition for “qualified jurisdiction,” as follows:

- (s) Qualified jurisdiction means:
  - (i) Any jurisdiction in which a designated offshore securities market, as defined in Regulation S, exists;
  - (ii) Any jurisdiction that has a securities commission that has entered into a bilateral Memorandum of Understanding directly with the SEC regarding enforcement cooperation;
  - (iii) Any jurisdiction that has a securities commission that is a signatory to the International Organization of Securities Commissions Multilateral Memorandum of Understanding; and
  - (iv) Any other jurisdiction designated as a “qualified jurisdiction” by the Board, in consultation with the other federal banking agencies, the SEC, and the CFTC.

<sup>55</sup> We believe it is appropriate to reference the standard for public offering in the jurisdiction of the offering, recognizing that the U.S. standard may not fit within the legal framework in some jurisdictions outside the United States. Our proposed rule does use the U.S. standard for a private offering under Section 4(2) of the Securities Act of 1933 in order to define what would not be a public offering. This, along with the requirement that the offering be conducted pursuant to the laws of a qualified jurisdiction, should allay any concerns the agencies may have regarding the offering standards for foreign funds that would not be covered funds.

exchanges and less than 50 percent of the ownership interests in the issuer were sold in such offerings;<sup>56</sup> and

(3) (i) The issuer provides at least weekly liquidity to its investors and calculates, at least weekly, a net asset value, or its equivalent, which is made available to current and potential investors; or (ii) ownership interests in the issuer are listed on a securities exchange regulated pursuant to the laws of a qualified jurisdiction;

; and

(E) Substantially all of the ownership interests in the issuer are not sold to another issuer that is not a covered fund.”<sup>57</sup>

In addition, with respect to monitoring and enforcement, we have considered what compliance program and recordkeeping requirements could be implemented to ensure that the agencies have a view into banking entities’ foreign fund activities in order to monitor compliance with our proposal. We propose that the agencies amend Appendix C, Section II of the proposed rule by adding a new Subsection C, which we set forth in Appendix A to this letter.

#### **4. Advantages**

Our recommendation has several advantages over the Foreign Funds Designation, as currently drafted. First, we believe that the set of characteristics described under subparagraph D are key features of regulated and publicly offered foreign funds that could not be satisfied by a traditional hedge fund or private equity fund – certainly a fund with those characteristics could not rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act if it were organized in the United States. This approach will give the proposed rule sufficient breadth to cover any foreign funds that are truly hedge funds or private equity funds, while allowing banking entities to continue to offer traditional asset management products to their customers outside the United States. As a result, for purposes of coverage under the Volcker Rule, analogous U.S. and foreign funds would be treated comparably.

Second, the modification is fully consistent with the discretion given to the agencies on the face of the statute to determine whether, and how, to designate “similar funds,” and does not

---

<sup>56</sup> Our proposed requirement that at least 50 percent of the ownership interests in a listed fund be sold in a public offering or series of related offerings is designed to prevent a banking entity from using a nominal listing to satisfy the “listing requirement.”

<sup>57</sup> Subsection E is intended to allow banking entities to continue to sponsor funds that are part of a fund of funds structure. Some JPMAM funds are organized to be sold almost exclusively to fund of funds. Because these funds typically could not meet the public offering criteria of Section \_\_\_\_\_.10(b)(1)(iii)(D)(II) of our proposed definition, these funds would be “covered funds” even though they are being sold almost exclusively through a fund of funds that is not a covered fund.

require the agencies to rely on Section 13(d)(1)(J) of the BHC Act, which authorizes the agencies to exempt activities from the limitations of the Volcker Rule that would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.<sup>58</sup> Rather than create exceptions to an overbroad definition, we believe the better approach is to craft a more tailored, yet still robust, definition of covered fund and to address any concerns regarding gaps if, and when, they are identified.<sup>59</sup> The agencies will retain the ability to amend the definition of covered fund and to designate additional “similar” funds as covered funds and, if necessary, could also pursue anti-evasion actions pursuant to the statute.

Finally, this approach ensures that funds that will not be covered by the Volcker Rule are subject to an acceptable level of regulation. To that end, our recommendation provides that a foreign issuer that is not covered by the Volcker Rule be regulated under the laws of a “qualified jurisdiction.” Although the agencies could define qualified jurisdiction using any criteria they deem appropriate, we recommend that the agencies define qualified jurisdiction as follows: (1) any jurisdiction in which a designated offshore securities market, as defined in Regulation S, exists;<sup>60</sup> (2) any jurisdiction that has a securities commission that has entered into a bilateral Memorandum of Understanding directly with the SEC regarding enforcement cooperation; (3) any jurisdiction that has a securities commission that is a signatory to the International Organization of Securities Commissions Multilateral Memorandum of Understanding<sup>61</sup>; and (4) any other jurisdiction so designated by the Board, in consultation

---

<sup>58</sup> Although Question 223 in the preamble to the proposed rule suggests Section 13(d)(1)(J) might be used to address issues of overbreadth, and although we support the use of Section 13(d)(1)(J) where appropriate, use of this authority is not necessary or appropriate in this context.

<sup>59</sup> Question 223 also suggests defining a covered fund by determining whether a fund satisfies any one of a list of characteristics. Given the broad list of characteristics identified in the question and the fact that the agencies suggested that meeting one of the characteristics would make a fund a “covered fund,” we believe that such an approach, as proposed, would have a similar overbroad effect of covering funds that are not similar to traditional hedge funds or private equity funds. For example, “sells securities and other assets short” was listed in Question 223 as one of the hedge fund and private equity fund characteristics. Many registered U.S. mutual funds, including several funds advised by JPMAM, engage in some shorting strategies as a component of the fund’s overall strategy (e.g., long short funds and 130/30 funds). Although registered mutual funds that employ shorting strategies do not meet many of the other characteristics listed and, of course, are not “traditional” hedge funds and private equity funds, Question 223 seems to suggest that they would be “covered funds.”

<sup>60</sup> Rule 902(b) of Regulation S (17 C.F.R. § 230.902(b)). Attributes considered by the SEC in determining which foreign securities markets are designated include: organization under foreign law, association with a generally recognized community of brokers, dealers, banks, or other professional intermediaries with an established operating history, oversight by a governmental or self-regulatory body, oversight standards set by an existing body of law, reporting of securities transactions on a regular basis to a governmental or self-regulatory body, a system for exchange of price quotations through common communications media and an organized clearance and settlement system. *Id.*

<sup>61</sup> The International Organization of Securities Commissions (“IOSCO”) is a multilateral international organization of securities regulators. IOSCO members have resolved to, among other things, (1) cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets; (2)

with the other federal banking agencies, the SEC, and the CFTC. Our recommended approach to the definition of qualified jurisdiction references existing, objective standards that would avoid the need to create new designations and would ensure the robustness of the regulatory scheme applicable to foreign funds that are not covered by the Volcker Rule.<sup>62</sup>

## 5. Consequences

If the Foreign Funds Designation were not modified, in order to engage in the asset management business internationally, JPMAM and other banking entities would need to conform their non-U.S. activities with respect to funds that are not commonly understood to be hedge funds or private equity funds to the limitations contained in the proposed rule. The limitations in Section \_\_.11 (which include, among other things, limitations on name sharing, ownership of interests in funds and employee investments in funds) and Section \_\_.16 (limitations on a banking entity's entering into covered transactions with covered funds) would impose significant costs on JPMAM and other banking entities, without any real regulatory benefit. For example, the prohibition that a covered fund not share the same name as the banking entity may, depending on the fund's legal structure and applicable regulation, require a shareholder vote and may, in fact, raise issues under applicable law in certain jurisdictions that require the fund name to be clear and not misleading.<sup>63</sup> The 3% per fund ownership limit would need to be monitored by banking entities on a continuous basis because many of the captured funds provide daily liquidity to investors. That requirement will force banking entities to sell interests in funds that may be the equivalent of U.S. mutual funds if, on a single day, the banking entity's position exceeds the 3% limit solely because other investors have redeemed. Furthermore, if the proposed rule were not modified, banking entities could be required to deduct the amount of their interest in foreign funds from the calculation of their Tier 1 capital.<sup>64</sup> The prohibitions contained in Section \_\_.16 (the so-called "Super 23A" provision) would force large fund complexes, like ours, to cease having an

---

exchange information on their respective experiences in order to promote the development of domestic securities markets; (3) unite their efforts to establish standards and an effective surveillance of international securities transactions; and (4) provide mutual assistance to promote the integrity of the markets by a rigorous application of international standards and by effective enforcement against offenses. IOSCO's "Objectives and Principles of Securities Regulation" is the benchmark standard for securities regulators and one of the twelve key standards for financial stability as recognized by the Financial Stability Board (See U.S. Securities and Exchange Commission, "SEC Participation in International Organizations" <http://www.sec.gov/about/offices/oia.shtml>).

<sup>62</sup> We also believe that such an approach would not implicate foreign policy considerations that, although within the agencies' authority to undertake, may be time consuming.

<sup>63</sup> See, e.g., Regulation 15(9) of the U.K. Open End Investment Company Regulations. Among the factors that the U.K.'s Financial Services Authority considers in determining whether a fund name is "undesirable or misleading" is whether the fund name "might mislead investors into thinking that persons other than the authorized fund manager are responsible for the authorized fund."

<sup>64</sup> Section \_\_.12(d) of the proposed rule.

affiliated entity serve as the fund's custodian or engage in principal trades on behalf of the fund, both of which services are permitted under non-U.S. law and, with respect to an affiliate providing custodial services to a fund, is also permitted under the Investment Company Act for JPMAM's U.S. mutual funds. The cumulative effect of those burdens and the long time period required to satisfy the Section .11 and Section .16 requirements could prevent JPMAM and other banking entities from launching new retail products in the existing fund families for a considerable time period after the Volcker Rule's effective date. Although banking entities have been on notice since July 2010 that traditional hedge funds and private equity funds would be subject to the Volcker Rule, it could not have been anticipated that regulated retail funds such as UCITS could become covered funds.

Even if it were possible to comply with the limitations and prohibitions mentioned above, those restrictions, and the additional costs associated with compliance, would place JPMAM at a competitive disadvantage to U.S. and non-U.S. asset managers that are not subject to the Volcker Rule and that are not required to modify their asset management businesses. We do not believe that this was the result intended by the agencies in formulating the Foreign Funds Designation and it was not the result intended by Congress.

#### 6. Definition of "Banking Entity"

Under the Volcker Rule and the proposed rule, "banking entity" means, in relevant part, "any insured depository institution . . . and any affiliate or subsidiary of [an insured depository institution]."<sup>65</sup> The terms "affiliate" and "subsidiary" are defined by reference to the very broad definitions of those terms under the BHC Act.

In the preamble to the proposed rule, the agencies noted that mutual funds, including registered investment companies, are structured such that they are not affiliates or subsidiaries of banking entities under the BHC Act and thus, would not themselves be banking entities under the Volcker Rule.<sup>66</sup> There is, however, no provision in the proposed rule that explicitly carves out mutual funds and other registered investment companies from the definition of banking entity. Question 8 inquires whether the agencies should make such an express exclusion from the definition of banking entity in the proposed rule.

Although we agree that, as a general matter, registered investment companies are not, and should not, be considered affiliates or subsidiaries of the banking entities that organize, sponsor, invest in, advise or manage them, we support the clarification of this point in the proposed rule. If such an approach were adopted, we recommend that the express exclusion be made broad enough to also exclude foreign funds that are analogous to registered investment companies. There is no regulatory reason that analogous U.S. and foreign funds

---

<sup>65</sup> Section 13(h)(1) of the BHC Act and Section .2(e) of the proposed rule, respectively.

<sup>66</sup> See proposed rule at page 68856.

should be treated differently in this respect. We believe that the following modification to the definition of banking entity would be consistent with the agencies' proposition and would appropriately tailor the exclusion. Section \_\_.2(e)(4) would read:

- "(4) Any affiliate or subsidiary described in paragraph (1), (2), or (3) of this section, other than an affiliate or subsidiary that is:
  - (i) A covered fund that is organized, offered and held by a banking entity pursuant to § \_\_.11 and in accordance with the provisions of subpart C of this part, including the provisions governing relationships between a covered fund and a banking entity;
  - (ii) An entity that is controlled by a covered fund described in paragraph (e)(4)(i) of this section; or
  - (iii) An issuer, as defined in section 2(a)(22) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(22)), that is
    - (A) A registered investment company under the Investment Company Act of 1940 (15 U.S.C. 80a-8); or
    - (B) Organized outside the United States and is not a covered fund pursuant to section \_\_.10(b)(1)(iii)." <sup>67</sup>

We believe that this approach would address a concern we have raised throughout this letter regarding the equivalent treatment of U.S. and foreign funds. Our proposal is intended only to ensure that registered investment companies and foreign funds are not included in the definition of "banking entity" and does not discuss other concerns that the proposed definition of "banking entity" raises, which we expect other comment letters will address.

## 7. Conclusion Regarding Foreign Funds and Banking Entities

The foregoing is intended to bring attention to the effect that the Foreign Funds Designation and the proposed rule's definition of banking entity would have on the international asset management activities of U.S. banking entities, such as JPMAM. We know that other commenters, such as SIFMA of which we have been an active member, will raise similar concerns to those we have raised in this letter. SIFMA's approach to these concerns, which we generally support, may be broader than the tailored solutions we have recommended. To the extent that the agencies accept some or all of these broader recommendations, we believe such recommendations should apply to foreign funds to the extent appropriate. We also join in full support of SIFMA's positions on other aspects of the Volcker Rule that focus on the covered funds portion of the proposed rule.

---

<sup>67</sup> This refers to Section \_\_.10(b)(1)(iii) of the proposed rule as revised pursuant to our recommendation above.

We firmly believe that any rulemaking by the agencies should reflect Congress' intent that the limitations of the Volcker Rule extend only to funds similar to traditional hedge funds and private equity funds because Congress would not have intended that analogous U.S. and foreign funds be treated differently. In addition to implementing that intent, we believe that the agencies should consider the economic and organizational impact of the proposed rule on both the U.S. and non-U.S. operations of banking entities and weigh that against discernible regulatory benefits. We believe that the aspects of the proposed rule discussed in this letter would have negative economic and organizational effects on the international asset management activities of U.S. banking entities, including JPMAM, with little regulatory benefit. We believe our tailored recommendations would minimize negative impacts while ensuring a robust regulatory scheme that is consistent with the statute and Congress' intent.

## B. Corporate Bonds

JPMAM oversees more than \$800 billion in fixed income assets on behalf of its customers. Given our active presence on behalf of our customers in the fixed income markets, we are concerned that the proposed rule, as currently drafted, could reduce the value of our customers' current investments in corporate bonds and inhibit our customers' ability to access the corporate bond market in the future. While we have described these concerns from the perspective of JPMorgan's market makers above, we believe it is important to highlight the serious concerns we have regarding the effect of the proposed rule from the perspective of our asset management business. We focus in particular on the impact on the corporate bond market.

### 1. The Corporate Bond Market

Corporate bonds are inherently less liquid than equities because corporate bonds are traded over the counter (that is, directly between two parties, rather than through an exchange). Moreover, issuers of corporate bonds often have multiple bond issues outstanding with smaller or older issues (which are often described as "off-the-run") having less liquidity than more recent or larger issues (which are often described as "on-the-run"), which have greater liquidity.

Liquidity in the corporate bond market has generally declined since 2007, with trading becoming increasingly concentrated in a smaller number of issuers over this time period.<sup>68</sup>

---

<sup>68</sup> From January 1, 2011 to September 30, 2011, approximately 5% of the total number of issuers in the U.S. investment grade corporate bond universe accounted for 50% of trading volume according to MarketAxess data. Trading has also increasingly focused on larger issues. In the first three quarters of 2011, turnover (on an annualized basis) in issues greater than \$1 billion was approximately 1.1x versus only approximately 0.8x in 2006. By contrast, turnover (on an annualized basis) in issues between \$250 and \$500 million has declined from approximately 0.65x in 2006 to approximately 0.5x in the first three quarters of 2011. Similar trends were also observed in issue sizes of \$500 - \$750 million and \$750 million to \$1 billion (Barclays Capital, *U.S. Credit Alpha*, November 18, 2011, at 6, figure 5). Trading volume in older securities has shown a similar pattern of decline (Id. at 7, figure 7).

Our customers' portfolios include both on-the-run and off-the-run securities, and, as a result of decreased liquidity, our customers have experienced increased transaction costs associated with purchases or sales in all issues. Maturity restrictions, investor preferences and transaction costs make it impractical and often impossible for customers to concentrate their holdings only in on-the-run issues and simply holding the off-the-run investments to maturity may not be possible for some customers who may need to sell off-the-run issues based on, for example, cash flow requirements, pension obligations or asset allocation shifts.

As market makers, securities dealers facilitate trading in both on-the-run and off-the-run corporate bond issues, among other securities, by standing ready to buy and sell. In a very liquid market, such as equity securities, market makers are able to sell securities they buy, and buy securities they need to sell, quickly and easily. Corporate bond markets and fixed income markets in general are by their nature (e.g., multiple different issues from a single issuer) less liquid than other markets, and market makers therefore must buy and hold securities in their inventory longer than in other markets. Thus, the market for off-the-run issues has led market makers to hold securities in their inventory for longer time periods.

## 2. Restrictions on Market Making

Unless the final rule very clearly permits the type of inventory management activity that we describe above, market makers simply will not be able to provide the type of intermediation services that underpin certain sectors of the corporate bond market. A restrictive approach to inventory holding periods, in combination with the uncertainty associated with the phrase "reasonably expected near term demands" would, we believe, significantly decrease the liquidity of the corporate bond market because it would result in market makers being less willing to transact in securities that they are not confident they can dispose of quickly. The situation is only worsened by the requirement in the proposed rule that market making activities be "designed to generate revenues from fees, commissions, bid/ask spreads or other income not attributable to . . . [a]ppreciation in the value of covered financial positions it holds. . . ."<sup>69</sup> Given the sometimes significant holding periods for less liquid issues in the corporate bond market, market makers often do generate revenues based on the appreciation in value of a security.

## 3. Restrictions in the Context of other Regulatory Developments

The effective date of the Volcker Rule coincides with the implementation of other regulatory measures that may also reduce liquidity in the corporate bond market. Specifically, Basel III risk-weighted asset calculations will change the economics of positioning corporate bond inventories. Additionally, for European banks which may be evaluating the risk weighted asset impact of selected capital markets activities in connection with meeting the European Bank Association's capital requirements based on "Basel II.5" calculations, the requirement to comply with the Volcker Rule when trading with U.S. counterparties outside of the United

---

<sup>69</sup> Section \_\_.4(b)(2)(v) of the proposed rule.

States could be significant enough to support a decision to reduce their market making activities. Fewer active market makers will further pressure the pricing and liquidity of corporate bonds. In light of this, we think it is important that the proposed rule be modified so that it does not exacerbate the pressure on the liquidity of this market.

#### **4. Effect on Our Customers**

We believe that the proposed rule, if not modified, will result in significantly decreased liquidity in the corporate bond market for our customers and other institutional and individual investors. This markedly lower level of liquidity will result in an immediate negative impact to the value of securities currently held by investors, based on the liquidity premium, and will result in increased transaction costs for future transactions in these securities.<sup>70</sup> In revising the proposed rule, we urge the agencies to consider the impact of the proposed rule on investors in less liquid markets, such as corporate bonds, who rely on market makers to ensure an available, functioning market.

#### **C. Public Welfare Investments Abroad**

We believe it is important that the proposed rule treat analogous U.S. and non-U.S. activities and investments similarly. The proposed rule implements the statutory exemption<sup>71</sup> from the restrictions of the Volcker Rule with respect to investments in small business investment companies (“SBICs”), investments “designed primarily to promote the public welfare, of the type permitted under [12 U.S.C. § 24(Eleventh)], and certain investments that are qualified rehabilitation expenditures.”<sup>72</sup>

We urge the agencies to clarify in the final rules that the exemption also extends to those investments “of the type permitted under [12 U.S.C. 24(Eleventh)]” made outside the United States, including through U.S. and non-U.S. funds.<sup>73</sup>

---

<sup>70</sup> A recent study by Oliver Wyman has estimated that investors could suffer a \$90.315 billion mark to market loss caused by a repricing of the liquidity premium, as well as an additional \$1.4 billion of higher transaction costs going forward (Oliver Wyman, Volcker Impact Analysis December 11, 2011).

<sup>71</sup> 12 U.S.C. 1851(d)(E).

<sup>72</sup> Section 13(a) of the proposed rule.

<sup>73</sup> Our letter addresses only this narrow concern regarding the proposed rule’s implementation of the statutory exemption for SBICs and other public welfare investments. We expect other commenters will address additional concerns, including with respect to the proposed rule’s application of “Super 23A” to SBICs despite their being exempted from the definition of “covered fund.”

## **1. Impact Investing**

Many banking entities, including J.P. Morgan, have developed investment strategies to assist in the market of impact investing—that is, investing with the intent to generate a reasonable rate of financial return, while also benefitting low- and moderate income communities both in the United States and around the world. Although the emergence and growth of the impact investment market is a worldwide trend, currently, a majority of the investable opportunities lie in the emerging markets. U.S. governmental agencies, including U.S. Agency for International Development and the Overseas Private Investment Corporation, support those efforts, recognizing that such overseas impact investments help advance U.S. foreign policy interests and promote international development.

## **2. Clarification Needed**

We believe that the proper implementation of the statutory text, and indeed the proper interpretation of the proposed rule, requires that the exemption for public welfare investments extend to such investments made outside the United States. The statutory and regulatory phrasing, “of the type,” conveys that this exemption should be interpreted broadly and that 12 U.S.C. § 24(Eleventh) merely provides an example of, but does not circumscribe, the type of investments permitted under this exemption. As Senator Merkley noted, the exemption “is flexible enough to permit the regulators to include other similar low-risk investments with a public welfare purpose.”<sup>74</sup> A contrary reading would make the words “of the type” superfluous. We believe the agencies should confirm this interpretation in the final rules and make clear that the reference to 12 U.S.C. § 24 is not intended to limit permissible public welfare investments to investments in the United States.

A banking entity should be permitted to conduct impact investing outside the United States through funds, so long as the banking entity can demonstrate that such investments made by the fund advance a public welfare purpose “of the type” (*i.e.*, analogous to) investments permitted by 12 U.S.C. § 24(Eleventh). We believe this interpretation is required by the statutory text and is consistent with congressional intent, and we suggest the agencies make this clear in the final rules.

## **IV. Asset-Liability Management**

### **A. Asset-Liability Management is a Foundation of Safety and Soundness**

For large, complex banking institutions, asset-liability management (“ALM”) is one of the foundations of bank safety and soundness and is integral to the stability of the U.S. and global financial systems.

---

<sup>74</sup> Merkley-Levin Colloquy, 156 CONG. REC. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).

Indeed, the growing regulatory focus on stress tests for large banking institutions, including JPMorgan, such as the Comprehensive Capital Analysis and Review process, clearly demonstrates the central importance of a prudent and well-managed ALM function. If stress tests are designed to diagnose potential safety and soundness problems in the event of potential market or economic shocks, prompt ALM actions are required as the prescription for limiting the risks that stress testing identifies.

In its study on the Volcker Rule, the FSOC recognized the importance of these issues and clearly concluded that the Volcker Rule should not prohibit ALM activities. In its guidance, the FSOC stated: "All commercial banks, regardless of size, conduct ALM that helps the institution manage to a desired interest rate and liquidity risk profile. This study recognizes that ALM activities are clearly intended to be permitted activities, and are an important risk mitigation tool."<sup>75</sup>

The proposed rule, however, expands the scope of the Dodd-Frank Act and therefore brings within its prohibitions ALM activities that are important aids to safety and soundness. Oddly, while the FSOC study recommended an exemption that included both asset-liability and liquidity risk management, for much the same reasons, the proposed rule included only the latter. The result is that the proposed rule seems to have been written with traditional dealer and market-making trading activity in mind, and creates serious problems for legitimate ALM activity.

As currently structured, many ALM activities should be permissible under the proposed rule, because they pass the purpose test and would not be booked in a "market risk capital trading" book. Another group of ALM activities will be permissible to the extent they fall within the exclusion provided in the proposed rule for *bona fide* "liquidity management" activities—although, as discussed further below, liquidity management is only one small part of a banking institution's overall ALM activities, and the exclusion is so narrow in scope and restrictive in operation that it would not even permit many *bona fide* liquidity management activities, thus making the exclusion unworkable even for this narrow subset of ALM activities. Finally, while some ALM activities may be permitted by the proposed rule under its exception for "risk-mitigating hedging" activities, many legitimate, useful ALM activities will not, because that exception, as noted above, does not appear to have been drafted with ALM in mind, is subject to too many restrictive conditions, and is thus too narrow. Accordingly, while certain ALM activities will be permissible, equally valid ALM activities – although they are not speculative in nature, or entered into principally for "the purpose of near term resale or otherwise with the intent to resell in order to profit from short-term price movements"—could nonetheless be deemed, or even presumed to be, prohibited proprietary trading.

We believe that the final rule should provide for an explicit exclusion for ALM activities, which would be broad enough to include the proper range of liquidity management activities. Like the current exclusion for liquidity management activities, the exclusion for *bona fide*

---

<sup>75</sup> See FSOC Study at page 47.

ALM activities would be conditioned on appropriate requirements that ensure such activities will not be used to evade the statutory prohibition on proprietary trading.

## **B. Many ALM Activities Would be Captured by the Definition of Trading Account**

While many securities utilized in asset-liability management are accounted for as available-for-sale ("AFS") securities, many other traditional and long-established ALM activities often involve the use of instruments that would be required to be accounted for in the market risk capital trading account of the entity, thereby meeting the market risk capital test of the proposed rule. In addition, some of these ALM activities may require, in order to manage the relevant risks effectively, the exiting of a position within 60 days, thereby falling within the purpose test of the proposed rule.

The need to exit positions quickly arises because the structural risks of the firm are constantly changing due to the dynamic nature of the asset and liability flows and the impact of changing interest rates. The change in market value sensitivity (or "drift") of certain assets and liabilities requires continuous hedging of the structural risk book, which is often best managed through the use of securities or derivatives accounted for in the market risk capital trading account, or by entering and exiting a position within 60 days. Thus, unless the banking entity were able to determine that the risk mitigating exemption or the liquidity management exclusion applied, these activities would be deemed—or even presumed to be—proprietary trading. For example:

- One of the most traditional roles of the ALM function is to manage the banking entity's earnings at risk—that is, the risk that changes in interest rates will affect in different ways the value of the firm's liabilities and assets, such as its deposits and loan portfolio. Banking entities must also manage the mismatches in the maturity profiles of their assets and liabilities, and generally do so through use of their investment securities portfolio, thereby adding more assets to their balance sheets. Hedging strategies to protect the banking entity's resultant net interest income and interest rate margins from interest rate and yield curve changes, as well as foreign exchange fluctuations, include the use of options and derivatives that must be booked in the market risk capital trading account. Furthermore, because these derivatives are hedging the interest rate volatility arising from continuous balance sheet changes, they often settle within 60 days.
- A banking entity must manage the value of its mortgage servicing right asset, a right to service mortgages it originates or purchases, and one of the most volatile, and interest rate sensitive, assets on its balance sheet. In order to protect the value of the mortgage servicing right asset, the firm must manage the interest rate risk by using, among other instruments, interest rate swaps. These swaps would be booked in the market risk capital trading account and because of the volatility associated with this asset, such interest rate swaps are often settled within 60 days.

- Because the AFS investment securities portfolio of a banking entity is generally held for a long-term time horizon, it is often necessary manage the credit risk associated with these securities. To do so, the banking entity may buy protection in the credit default swap markets. The credit default swap is likely to be included in the entity's market risk capital trading account, and because of volatility in markets at any given point in time that is giving rise to the credit concerns of the underlying credit, these credit default swap positions may be settled within 60 days.
- Finally, a new type of volatility may be introduced to a firm's balance sheet as a result of the proposed capital rules under Basel III, which require capital to be held against certain positions in the Other Comprehensive Income ("OCI") Account (a component of stockholders equity).<sup>76</sup> In order to protect the banking entity's capital position from the excessive volatility that could arise in OCI from movements in interest rates or changes in the credit spreads, the firm may choose to hedge such volatility through the use of options, swaps, or other non-AFS instruments. Derivatives used as part of these hedging transactions will be booked in the market risk capital trading account and, because of the type of volatility they are hedging, may settle within 60 days.

In the above examples, derivatives trades that may be settled within 60 days are being used for prudent asset-liability management purposes. Under the statutory language, a "trading account" comprising the short-term derivatives described above and used to manage the banking entity's risks is not covered, as the purpose of each of the trades is to protect the firm from movements in interest rate, changes in credit conditions, or other market risks affecting the value of one of the firm's assets or liabilities; the purpose is not to profit from short-term price movements. Nonetheless, under the proposed rule, because of their short-term nature, these positions are presumed to be prohibited proprietary trading. This presumption is counterfactual, and the outcome under the proposed rule is inconsistent with the statute. Furthermore, as discussed below, the use of these strategies may not get the benefit of the risk mitigation exception or the liquidity management exclusion of the proposed rule because of the limited nature and restrictive conditions set forth in such exceptions. Thus, the ability of a banking entity to manage the structural risk of its balance sheet would be adversely and improperly affected.

We also note that while we believe the market risk capital test will cover some of these valid ALM strategies (and some hedging strategies employed in our investment bank), we actually do not know, because the market risk rules under Basel II.5 have not been finalized. In this regard, it is particularly difficult to determine the application of these market risk rules to the Volcker Rule proposed rule as: (1) many banking entities, including the Firm, are still very much in the process of analyzing the proposed market risk rules in order to determine which types of assets and liabilities would be deemed to be "trading positions" and what types of

---

<sup>76</sup> We strongly oppose this proposal for other reasons. See, Letter of The Clearing House Association, dated October 27, 2011. <http://www.theclearinghouse.org/index.html?f=073030>.

positions would be deemed to be “covered positions” under the proposed rules, and thus it is not possible at this time to determine how ALM activities will be impacted by the interplay of these two sets of proposed rules; (2) it is not certain when the proposed market risk rules will become final, and thus, under which set of “market risk capital” tests a banking entity will be subject at the time the Volcker Rule proposed rule become final; and (3) the types of documentation and compliance regimes necessary to establish compliance with the proposed rules may differ depending upon which set of proposed market risk capital tests is in effect at the time the Volcker Rule proposed rule becomes effective.

### C. Deficiencies in the Risk Mitigation Hedging Exemption

The statute contains an exemption for risk-mitigating hedging activity, and some ALM activity would qualify for that exemption. However, the exemption appears to contemplate the type of hedging that occurs when a market intermediary enters into transactions to hedge its risk with customers or to meet anticipated demands of customers. In contrast, management of balance sheet and other risk requires extensive forecasting and stress tests so that the ALM function can position its portfolios to manage against anticipated risks. Thus, as currently drafted, the exemption would fail to protect—or, to much the same effect, leave in doubt the protection of—numerous legitimate ALM hedging activities. The same is true with respect to hedging done in our investment bank at a more micro level.

#### 1. The conditions necessary to satisfy the exemption are too restrictive

As further illustrated below, the exemption for “risk mitigating hedging” is too restrictive and would not enable the broad range of actions that are required to manage the full complement of risks associated with a firm’s balance sheet.

(i) *“actions in connection with and related to.”* The proposed rule contains language indicating that a risk-mitigating hedge may only be used to mitigate risks to which the firm is already exposed. Anticipatory hedges are permissible only when the hedge is “established slightly before the banking entity becomes exposed to the underlying risk.” But appropriate risk mitigation activities often require that hedges be placed when it is *likely* that the firm will be exposed to the risk. The purpose of stress tests is to inform the firm about risks to which it *may become* exposed, and it is prudent for the firm, based upon that information, to take risk-mitigating actions. Further, it is impossible for any firm to perfectly anticipate the market moves that may adversely affect the entity’s assets and liabilities. Thus, no matter how sophisticated the stress tests or ALM analysis, flexibility is required with respect to the timing of the establishment of the hedges. In addition, depending on the size, scale and complexity of a particular institution’s positions relative to the depth and liquidity of the underlying instruments’ markets, safety and soundness considerations may require that the firm establish the positions over a period of time so that such transactions do not disrupt the markets.

(ii) *“reasonably correlated.”* The proposed rule requires that a hedging transaction be “reasonably correlated” to the risk being hedged and provides that if the hedge and related position “would result in the banking entity earning appreciably more profits on the hedge

than it stood to lose on the related position,” the hedge would likely to be deemed a proprietary trade.

These requirements could disqualify numerous legitimate hedging activities, as there are several reasons why a banking entity may earn appreciably more on a hedge position than it stands to lose on the related position—and yet, not be engaged in prohibited proprietary trading.

First, ALM positions may create profits that would not be offset, at least in an immediate profit-and-loss context, by losses in the underlying risk position. For example, derivative hedge positions may be marked to market (thereby creating P&L impact through the income statement), while the underlying position, such as a loan, is booked using accrual accounting (and thus would not give rise to a contemporaneous, offsetting P&L effect).

Second, precise correlations amongst and across different asset classes used in asset-liability management are difficult to determine. For example, the excess structural liability sensitivity arising from customer deposits creates a need for asset sensitivity on the balance sheet. A traditional ALM strategy to hedge such liability sensitivity is to purchase AFS investment securities. In these instances, as the characteristics of the hedge instrument are somewhat different than those of the underlying position, the hedge will react somewhat differently than the underlying position to the same market conditions and hence, generally, but not necessarily precisely, correlate to the underlying risk.

Third, maintenance of correlations at both the initiation and at the close of a hedging strategy may not be possible due to the fluid and convex nature of the balance sheet, as well as the liquidity of the market. As noted above, depending on the size, scale and complexity of the positions being established or unwound, flexibility is needed so the hedge or its unwind does not adversely affect the safety and soundness of the banking institution nor disrupt the markets. During these periods, therefore, high correlations will be more difficult to maintain.

Once again, this condition for the hedging exception appears to have been drafted with trading desks in mind, where both sides of a hedge are marked to market. It is a poor fit with ALM.

(iii) “*significant exposures that were not already present.*” The proposed rule requires that the hedging transaction not give rise to “significant exposures that were not already present” in the underlying position.

The proposed rule gives over-hedging as an example of prohibited proprietary trading. But in the ALM context, the inability to accurately forecast future outcomes requires that there be adequate flexibility for the estimation of—and hedging in respect of—such estimated future structural risks. In addition, as the probability of certain market and economic outcomes changes over time, the over or under hedging measurement will change relative to the underlying risk position.

Separately, and as importantly, asset-liability management strategies may often use instruments that will expose the banking entity to a risk that is itself not present in the

underlying position – and, thus give rise to an exposure “that was not already present.” In the example noted above, the use of an investment securities portfolio to manage the structural risk arising from customer deposits gives rise to basis risk.

2. ALM activities that were crucial during the financial crisis would have been endangered by the proposed rule.

Below are several examples of asset-liability hedging strategies employed by JPMorgan during the crisis that enabled it to successfully deal with the market, credit, interest rate, and liquidity risks that arose during that period. Some of these activities could be deemed prohibited proprietary trading under the proposed rule, and would not seem to fall within the risk-mitigating hedging exception:

*Hedging the volatility and interest rate risk of the mortgage servicing right asset:* In the days preceding Lehman's Chapter 11 filing on September 15, 2008, a review of JPMorgan's mortgage servicing right asset indicated that it was at significant risk for loss of value under some of the Firm's risk scenarios. Because the mortgage servicing right is very interest rate sensitive, a spike in volatility from falling rates would have increased the convexity of the mortgage servicing right asset and resulted in the Firm ending up with a large open, unhedged, risk position. Also, a counterparty default, even taking into consideration the collateral held by the Firm to mitigate the counterparty risk, would have deprived the Firm of the benefit of option positions previously entered into as protection. Accordingly, in anticipation of a possible counterparty default, the Firm determined it would be prudent to purchase additional options, in excess of its then open risk positions, in order to protect the Firm against “wrong way” market and counterparty risk. After the events about which we were concerned actually occurred, the Firm sold the excess coverage, which resulted in gains for the Firm.

Under the proposed rule, this activity could likely have been deemed prohibited proprietary trading (as the derivatives involved in the hedging strategy were booked in the market risk capital trading book) and may not have qualified as hedging because (1) the actions taken were forward looking and anticipatory nature; (2) the purchase of additional hedges could have been deemed over-hedging; and (3) the gains realized upon the unwind of the hedges could have been deemed “appreciably more profits on the hedge than [we] stood to lose on the related position.”

*Managing credit risk by use of credit derivatives:* Leading into and throughout the crisis, the Firm closely monitored its credit portfolio to assess how the market events that were unfolding might affect its balance sheet and structural risks. Analysis indicated early stress conditions in the credit markets, and we were therefore concerned that more serious and accelerated underlying credit deterioration was occurring in the short term than was generally reflected in market prices. (The general market view was reflected in the high-yield credit spread curve which was, at the beginning of the crisis, very steep, indicating that the market believed that companies would likely not default in the short-term, but that severe credit losses were more likely to occur in the long term as the crisis continued in duration.)

To protect the Firm against credit losses that, based on its analysis, the Firm perceived were possible to occur in the near term, the Firm's ALM team used credit derivatives to purchase protection on high yield credit default swap indices with short term maturities and to sell protection on high yield credit default swap indices with longer-term maturities—in effect, taking a high yield curve flattening position in the credit derivatives market. This strategy resulted in the Firm recognizing some gains as near-term default risks increased. The gains recognized on these derivatives strategies offset in part the losses that occurred on credit assets held by the Firm.

Under the proposed rule, this activity could have been deemed prohibited proprietary trading. The derivatives used in the hedging strategy were booked in the market risk capital trading account and may not have qualified as hedging because: (1) the actions taken were forward-looking and anticipatory; (2) the Firm's purchases of the credit derivatives may not have been deemed "reasonably correlated" with the underlying risk, as different instruments were used to effect the hedging strategy than the assets giving rise to the risk; and (3) the gains realized upon the unwind of the hedges could have been determined to be larger than the countervailing risks.

*Managing deposit inflows by purchasing highly liquid securities:* As the crisis unfolded, JPMorgan experienced an unprecedented inflow of deposits (more than \$100 billion) reflecting a flight to quality. The Firm was faced with determining how to invest this excess cash, and how to earn a sufficient rate of return on these deposits in an extremely low-rate environment, so that it could pay interest on these funds without losing money—or needing to turn its customers away, which not only would have been bad business for us but destabilizing for the system. The Firm took several actions: it lent the excess funds in the inter-bank market, thereby helping to recirculate available liquidity to other financial institutions. But it also invested in both long-term and short-term highly liquid investment grade securities in order to obtain a rate of return sufficient to protect the Firm from compressing margins on its deposit base. Although the preponderance of the securities purchased were booked as AFS securities, many of the shorter-term securities were booked in the Firm's market risk capital trading account. The purchase of shorter-term securities was necessary because the Firm was not sure how sticky (or long term in nature) some of these deposits would be, and wanted to avoid an asset-liability mismatch. And some AFS securities were purchased and sold within 60 days as a prudent hedging response to the dynamic nature of the cash flows, and in order to manage the fluidity of the cash flows and the interest rate volatility and sensitivities such cash flows were creating. Use of this strategy enabled the Firm to protect itself against losses, helped its clients earn interest on the funds they had deposited with the Firm and recycled funds back into the wholesale markets.

Under the proposed rule, some components of this strategy could have been considered (or presumed to be) prohibited proprietary trading. Some securities were booked in the market risk capital trading account (or purchased and sold within 60 days), and would not have qualified as hedging because (1) the Firm's purchases might have been deemed to be a hedge that gave rise to a "risk that was not already present" on the Firm's balance sheet; (2) the

hedge securities may not have been deemed a hedge that “reasonably correlated” with the underlying risk (not only for the reason noted before, but also because the pace of the purchases or sales of hedge securities may not have matched precisely the pace of deposit inflows and outflows) and (3) the Firm’s eventual sale of such securities resulted in gains that could have been considered outsized to the risk being hedged (in part because that risk could not be quantified).

*Managing the value of the Firm’s assets and liabilities by purchasing expanded types of investment securities:* By early 2009, it had become apparent that additional ALM action was required. The credit environment had deteriorated further, and the Firm’s management was forecasting a significant economic slowdown that was likely to lead to a lower interest rate environment. In addition to the significant influx of deposits the Firm was experiencing, the Firm’s management was predicting lower loan demand, resulting in a significant structural balance sheet mismatch between assets and liabilities. In anticipation of these conditions, the Firm’s ALM team undertook an evaluation of the Firm’s investment securities portfolio and determined it would be prudent to increase the size and duration of the portfolio, as well as to increase diversification of the portfolio. Thus, in addition to agency MBS securities, which were the securities traditionally held by the investment securities portfolio, ALM activities expanded in scope to include other highly liquid securities. But, as the market dislocation associated with the crisis increased and credit spreads continued to widen, the portfolio was further expanded to include other top-of-the-capital structure securities and certain types of structured credit products to bring the asset-liability sensitivity of the Firm more in balance. This increased purchasing continued over several quarters of 2009. While the preponderance of the securities purchased were booked as AFS securities, the expanded strategy also involved the purchase of certain securities and derivatives that were booked in the Firm’s market risk capital trading account and, as a prudent response to the volatility in the credit markets, sometimes necessitated the purchase and sale, within 60 days, of AFS securities. This active – and proactive – positioning of the Firm’s ALM portfolio during the period enabled the Firm to manage successfully a balance sheet that was experiencing significant changes in volumes in its assets and liabilities with resulting interest rate volatility and sensitivity, and provided the Firm with a partial hedge against the changing market value of the Firm’s balance sheet.

Under the proposed rule, some aspects of this strategy could have been prohibited, for basically the same reasons described with respect to other strategies. As these examples demonstrate, JPMorgan’s ALM activities during the crisis involved pro-active management of the risks associated with its balance sheet. Many of these actions needed to be taken quickly, while many others required significant purchases or sales of securities over a period of time – as large purchases or sales needed to be managed in a way that was consistent with safety and soundness and without dislocating markets.

The actions taken by the Firm’s ALM team led to significant changes over the two-year period in the size, maturity profile, and composition of the Firm’s investment securities portfolio. All of these actions, irrespective of whether the securities and instruments

purchased and sold were accounted for as AFS investment securities or booked in the market risk capital trading account, were effected in order to protect the value of the assets and liabilities on the Firm's balance sheet, and not for the purpose of earning profit from short-term price movements. Under the proposed rule, it is at best unclear whether we could take similar actions to protect ourselves in the future. Thus, many of the most prudent, useful and successful strategies utilized by the Firm during the crisis could have been prohibited under the proposed rule. As discussed below, we believe there are more appropriate ways to ensure a prudent and effective operation of an ALM function, while at the same time ensuring sufficient safeguards are in place so that the statutory prohibition on proprietary trading set forth in the Volcker Rule is not evaded.

#### **D. Inapplicable Elements of the Risk Mitigation Hedging Exemption**

##### **1. The Metrics Required to be Applied are Meaningless When Applied to Legitimate ALM Activities**

The proposed rule requires five metrics to be applied to "risk mitigating hedging activities;" accordingly, under the proposed rule, ALM transactions that are booked in the entity's market risk capital trading account would be subject to these metrics. These measures include VAR, Stress VAR, VAR Exceedence, Risk Factor Sensitivities, and Risk Position Limits. It is true that VAR and these other metrics are used by the Firm in respect of the portion of the ALM portfolio which is marked-to-market. However, the purpose for such tests is to enable the Firm to understand the potential loss that could be incurred by these positions as a result of immediate changes in market rates – but not to determine the efficacy of the ALM hedging activity. And, while asset-liability risk management does use risk factor sensitivities and risk position limits in managing the risks associated with the portfolio, these metrics likewise do not help distinguish ALM activities from prohibited proprietary trading activities. Accordingly, while these metrics are used in risk management, they are of no use in distinguishing valid risk mitigating hedging activities from prohibited proprietary trading.

Most significantly, the application of the VAR-based measures to assets held by an ALM function would be extremely misleading. This is because many of the liabilities being managed, such as deposits, are not marked to market but, rather, are accounted for on an accrual basis. This accounting asymmetry means that while the VAR-based metrics will capture the changes in value of the ALM position, these metrics will not reflect the offsetting risk in the underlying structural balance sheet of the company—in essence, the VAR-based metric will be measuring only one side of the equation, not both. Accordingly, VAR measures will not gauge the extent to which the ALM position is actually offsetting the risk it is hedging. This accounting asymmetry renders the application of these metrics to ALM activities meaningless for Volcker Rule purposes.

## 2. The “Simultaneous Documentation” Requirement Is Overly Onerous and Not Necessary to Distinguish Proprietary Trading from Legitimate ALM Activities

The heavy documentation requirements for risk mitigating hedging activities are unrealistic and the requirement for contemporaneous documentation is unworkable. The proposed rule requires that for any risk mitigation hedging transactions “established at a level of organization that is different than the level of organization” establishing the positions, the entity must document “at the time” of the transaction (1) the purpose of that hedge transaction; (2) the positions the hedge is designed to reduce; and (3) the level of the organization that is establishing the hedge.

The significant documentation requirement imposed on the ALM function—which, by definition, is carried out on a desk that is different from the market-making desks giving rise to the risk or the operating business that is giving rise to the underlying credit or structural liability risk—means that ALM functions will *de facto* be subject to the unworkable documentation requirements of the proposed rule. Because the ALM function looks at the balance sheet in a macro, holistic way, determinations as to hedging strategies are generally developed by an investment committee that determines what risks the entity is being exposed to, and how best and how much to hedge them. The person executing the hedging position on behalf of the ALM function may not know the precise origin of the risk being hedged at the time of hedge execution. The unworkability of the documentation requirement becomes even more extreme in the context of necessary anticipatory hedging. Because hedging is dynamic and needs to be responsive to market conditions, the requirements that such documentation be “contemporaneous with” the establishment of the hedge, and that there be detailed documentation identifying the exact positions – or even portfolios of positions – that are intended to be hedged could inadvertently delay managers from establishing the very hedges required to maintain safety and soundness. This tension will be particularly acute during volatile market conditions – precisely when safety and soundness and market stability argue for quick action.

Further, it is unclear what benefits these additional documentation requirements provide, and how they would differ from or be supplemental to the policies and procedures that are already employed by a firm’s ALM function. It is not clear that the appropriate and already robust policies and procedures that are in place in a firm’s ALM function do not suffice. Because ALM functions should be given the same deference and latitude that the proposed rule accords the liquidity management function (at least in respect of the documentation requirements applicable to both activities), there is no reason that the documentation conditions that the proposed rule deems sufficient for liquidity management should not likewise be deemed sufficient and appropriate for transactions executed in furtherance of *bona fide* ALM activities.

In summary, given the restrictive and unworkable conditions required to be met for the “risk mitigating hedging” exemption of the proposed rule, it will be impossible for risk managers to know at the outset what may be deemed exempted and what may not. This attendant

uncertainty will chill the taking of appropriate actions and impair the exercise of this important function, thereby undermining a crucial safety and soundness function, often at times when it is most required.

#### E. The Liquidity Management Exclusion

While the proposed rule properly excludes liquidity management activities from the definition of trading account (thereby acknowledging that these activities are not for the purpose of selling in the near term or with the intent to resell in order to profit from short-term price movements), it nonetheless fails to fully implement the FSOC's finding that liquidity management activities must fall outside the Volcker Rule's definition of proprietary trading. That is because the proposed rule has so narrowly circumscribed the scope of excluded "bona fide liquidity management" activities that only a fraction of a firm's liquidity management activities will qualify for this treatment and, thus, the remainder could be prohibited by the Volcker Rule as impermissible proprietary trading. This result cannot be intended.

In particular, the following conditions that must be met in order to obtain the benefit of the exclusion present serious obstacles to effecting a legitimate and prudent liquidity management function:

- (i) "*near-term*" funding needs: Prudent liquidity management is responsible for ensuring that the entity is able to meet its commitments not only over the "short term" – but also over "medium-term" and "longer-time" horizons. In fact, the banking regulators' 2010 *Interagency Policy Statement on Funding and Liquidity Risk Management ("Liquidity Risk Policy")*<sup>77</sup>, requires firms to "ensure that their vulnerabilities to changing liquidity needs and liquidity capacities are appropriately assessed within meaningful time horizons, including intra-day, day-to-day, short-term weekly and monthly horizons, medium-term horizons of up to one year, and longer-term liquidity needs of one year or more."<sup>78</sup>

The consequence—which we believe must be unintended—of this near term requirement is to label any liquidity cushion of liquid securities held by the firm in excess of its "near-term" funding needs as prohibited proprietary trading. That is because under the proposed rule only the portion of the liquidity cushion that would meet a firm's "near term" funding needs will qualify for the liquidity management exclusion; the balance of the securities held as part of the liquidity cushion (which generally would be securities held in a market risk capital trading account) could be deemed prohibited proprietary trading. The result will be to limit prudent liquidity management practices and likely result in making banking entities less safe and less sound and the U.S. and global financial systems more vulnerable to liquidity stresses.

---

<sup>77</sup> "Interagency Policy Statement on Funding and Liquidity Risk Management" Office of the Comptroller of the Currency; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Office of Thrift Supervision; and National Credit Union Administration, Fed Reg. Vol. 75, No. 54, 13656, March 22, 2010.

<sup>78</sup> Id. at 13663.

(ii) *positions be “highly” liquid:* It is imprudent for all of a firm’s liquidity management positions to be invested only in highly liquid securities because prudent liquidity management requires appropriate asset allocation. Firms often invest their surplus funds in commercial paper, certificates of deposit, short-term loans, interbank deposits, Fed Funds and other similar instruments of creditworthy issuers, because these instruments, used in varying amounts at varying times, provide liquidity managers with the necessary flexibility to address the changing liquidity profile of the firm. Prohibiting the use of these types of instruments would be inappropriate for several reasons.

First, the liquidity of instruments changes from time to time in response to market conditions and thus, determining whether an instrument is highly liquid or merely liquid will be a facts and circumstances determination, depending on market conditions at any given point in time. Second, banking entities’ investment in commercial paper, short-term loans, interbank deposits and other similar products is an important way to recirculate available liquidity to help provide funding to others. Thus, prohibiting banking entities from investing their excess liquidity into these instruments would be detrimental to the safety and soundness of the entire banking system. Third, liquidity is not indicative of whether the purpose of a trade is short-term profit – and thus, it is not clear why or how this requirement furthers the intended purpose of the Volcker Rule.

(iii) *positions not give rise to “appreciable profits”:* The fact that a particular investment bears a higher rate of return than another does not convert the purpose of that investment from proper liquidity management to impermissible proprietary trading. In addition, concluding whether any particular liquidity management transaction creates impermissible “appreciable” profits is so subjective and uncertain a determination that it will only inhibit and impair the proper management of this important function.

(iv) *“specifically...authorize...the circumstances in which the particular instrument may or must be used.”* Liquidity management is a dynamic process, never more so than during periods of stress. It is a process that, by definition, requires continuous measurement and monitoring—and being able to take steps quickly to address any funding gaps (that is, any gaps between the timing of liquidity sources and liquidity uses). Because of the on-going nature of the reviews routinely performed by the function, and the breadth of the instruments taken into consideration depending on market and economic conditions at any point in time, requiring that the liquidity plan specifically detail the circumstances in which a particular instrument is to be used is too constrictive a condition to permit the proper functioning of a *bona fide* liquidity management function.

In summary, many *bona fide* liquidity management activities would not be permitted under the proposed rule’s exclusion. The restrictions will not permit the function to operate within a framework that is flexible enough to allow banking entities to manage their liquidity risks in prudent ways. As a result, the exclusion as currently set forth in the proposed rule could undermine banking entities’ safety and soundness.

## **F. Alternative approach**

The final rule should establish an exclusion from the definition of trading account for *bona fide* asset liability management, which would include and encompass *bona fide* liquidity management. Like the currently proposed exclusion for *bona fide* liquidity management, the ALM exclusion would be conditioned on meeting several criteria that are consistent, and in some instances go further than, those already included in the proposed rule. Such an exclusion is fully consistent with the language, purposes and history of the statute.

We therefore propose that there be an exclusion for any transaction effected for *bona fide* asset-liability management done in accordance with a firm's documented ALM policy that:

- Authorizes the particular instruments to be used for ALM and liquidity purposes, and describes the types circumstances under which such instruments would generally be expected to be used;
- Authorizes the hedging strategies for use in ALM activities or for addressing the liquidity needs of the firm as the macroeconomic and market environments change;
- Requires that any transaction contemplated and authorized by the plan be principally for the purpose of managing the balance sheet exposures and liquidity risks of the covered firm, and not principally 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;
- Requires that the ALM and liquidity portfolios be managed within appropriate controls documented in the ALM policy;
- Limits any positions taken for ALM or liquidity purposes to amounts that are consistent with the firm's balance sheet management and liquidity needs as defined in the ALM policy;
- Is consistent with all applicable regulatory guidance regarding asset-liability and liquidity management;
- Is approved by the firm's board of directors;
- Requires that the compensation arrangements of persons performing the ALM and liquidity management activities be designed so as not to reward proprietary risk taking;
- Requires that the firm shall have established a compliance and audit regime designed to ensure compliance with the rule; and

- Requires that the management of the ALM and liquidity management function (including its employees and officers) be separate from the primary dealer and market-making trading functions.

Under this construct, the agencies would have considerable assurance that ALM functions were being properly conducted, but financial institutions would retain the crucially important flexibility to manage their risks in appropriate and prudent ways. That is because under a properly organized, managed and supervised ALM function it would be difficult—if not impossible—for a proprietary trading desk or function to be secreted or camouflaged within an ALM function.<sup>79</sup> First, and foremost, because the ALM function is grounded in managing the structural risks of the enterprise, the banking entity would need to be able to demonstrate that each of the ALM strategies it undertook was in response to the results of stress tests or internal analysis conducted by the firm of its balance sheet risks. Each desk effecting ALM hedging strategies would need to be able to demonstrate how its activities are supervised, and that its transactions were within the defined mandates and limits established by its managers—who likewise would need to be able to demonstrate that those mandates and limits were directed by and were part of the ALM strategy established by the firm's ALM management. ALM management would need to be able to demonstrate that the instruments and strategies utilized by the various hedging personnel were established by it and were part of the written ALM plan and procedures, and that all of the ALM activities were reported to and monitored by the entity's independent risk management function. The entity would need to be able to demonstrate that the written plan and procedures were authorized by the entity's board of directors, and that its internal risk, compliance and audit personnel, independent of the ALM function, had performed adequate monitoring and testing of such processes and procedures to establish that the activities were in fact in compliance with the plan. And, as a further disincentive to proprietary trading occurring within the ALM function, the persons effecting ALM transactions would not be compensated to do so. Lastly, and not insignificantly, the banking entity would also know that its ALM activities are subject to regulatory examination and review. Thus, we believe the exemption would require that there exist within the ALM function managerial and supervisory structures to ensure that the function is being properly performed and appropriately controlled.

By proposing this exclusion we do not suggest that ALM activities be exempt from examination on safety and soundness grounds. Rather, as stated above, we fully expect robust examination and supervision to continue in the future. As noted in the introduction, we also note that draconian capital requirements on all trading positions, including those held for ALM purposes, are already a potent safety and soundness guarantee, as well as unfortunately a disincentive to engage in the activity.

\* \* \* \* \*

---

<sup>79</sup> We acknowledge it is always possible that a rogue trader situation can occur—but, as we note in the Overview, there appears no justification to promulgate a rule that presumes from the outset that covered entities would intentionally work to evade the rule.

We thank the agencies for their consideration of our comments. If you have any questions, please do not hesitate to call me at 212-270-0593.

Sincerely,



Barry L. Zubrow  
Executive Vice President

## **Appendix A**

### **Compliance Program for Foreign Funds**

Appendix C, Section II of the proposed rule would be amended to add a new Subsection C, as follows:

#### C. Foreign Fund Activities or Investments

A covered banking entity must establish, maintain and enforce written policies and procedures that are reasonably designed to document, describe, and monitor the covered banking entity's sponsorship activities with respect to, or investments in, funds organized and offered outside the United States (such funds, "foreign funds"), as follows:

Analysis of Foreign Funds: The covered banking entity's policies and procedures must specify how each foreign fund that the covered banking entity sponsors, organizes and offers, or in which the covered banking entity invests, will be analyzed to determine whether such foreign fund is a covered fund pursuant to § \_\_.10(b)(1). Such policies and procedures must provide that such analysis be appropriately documented and reported to management of the covered banking entity. To the extent that a foreign fund is determined not to be a covered fund, the following compliance program elements will apply.

Records Regarding Foreign Funds that are not Covered Funds: For foreign funds that are not covered funds and that the covered banking entity sponsors, organizes and offers, or in which the covered banking entity invests, the covered banking entity's written policies and procedures must specify that the covered banking entity maintain records that are sufficient to identify, as applicable:

- A description of each foreign fund (e.g., prospectus).
- For each foreign fund, a record that notes the basis upon which the covered banking entity has determined that the foreign fund is not a covered fund pursuant to § \_\_.10(b)(1)(iii), including the following elements:
  - jurisdiction of organization;
  - jurisdiction of registration or regulation;
  - each jurisdiction in which a public offering of the foreign fund's ownership interests has been made, or is intended to be made, and, with respect to funds that are publicly offered and listed on a foreign securities exchange, the percent of the foreign fund's ownership interests represented by such listing, or that are intended to be represented by such listing;

- how frequently investors are permitted to redeem their ownership interests and how frequently a net asset value, or its equivalent, is calculated; and
  - the securities exchange upon which the foreign fund's ownership interests are listed.
- The nature of the covered banking entity's sponsorship activities with respect to each foreign fund; and
- The date and amount of each investment by the covered banking entity in each foreign fund.

Ongoing Compliance of Investments in Foreign Funds that are not Covered

Funds: The covered banking entity's policies and procedures must specify how each foreign fund in which a banking entity maintains an ownership interest will be reviewed regularly to determine whether such foreign fund has become a covered fund pursuant to § \_\_.10(b)(1). With respect to foreign funds that are later determined to be covered funds, the covered banking entity's policies and procedures must also specify how the banking entity will ensure investments in such foreign funds will be brought into compliance with § \_\_.11 and the other provisions of Part [ ], as applicable.