THE FINANCIAL SERVICES ROUNDTABLE
Financing America's Economy

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Via electronic mail: volckeralternative@mail.house.gov

Chairman Spencer Bachus
House Financial Services Committee
2129 Rayburn HOB
Washington, DC 20515

The Securities Industry and Financial Markets Association[1] appreciates the opportunity to share our views on Section 619 of the Dodd-Frank Act, popularly known as the Volcker Rule, with the House Financial Services Committee in response to Chairman Bachus's request for public input on legislative alternatives to the Volcker Rule. We share the Chairman's concerns that the Volcker Rule, along with the regulations proposed by the agencies charged with implementing it, could have substantial adverse effects on the U.S. and global economies, the competitiveness of U.S. financial institutions, the availability of capital and credit, market liquidity, job growth and a wide range of market participants and investors. Moreover, we continue to believe that the Volcker Rule targets activities that did not contribute meaningfully to the 2008 financial crisis. We therefore strongly support the Chairman's initiative to explore a "less burdensome legislative alternative" to the Volcker Rule.[2]

In the first part of this letter, we discuss why a comprehensive re-evaluation of the statutory Volcker Rule would be prudent. The legislative process around the Volcker Rule was hampered by the absence of considered fact-finding and solicitation of informed viewpoints. The Senate conducted only two hearings on the Volcker Rule, and the draft discussed at those hearings was considerably more targeted than the version that Congress enacted. The House was not able to conduct even a single hearing because the Volcker Rule was originally proposed over a month after the House passed its financial regulatory reform bill. Indeed, major elements of the statutory text of the Volcker Rule were not agreed upon until the final overnight Dodd-Frank

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] Chairman Bachus Seeks Public's Input on Volcker Rule Alternative (Aug. 7, 2012), *available at* http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=306143.

conference session. In light of this legislative history, unintended consequences were inevitable. As such, we strongly support the efforts of Chairman Bachus and others in Congress to revisit the statutory text of the Volcker Rule in a considered and deliberate way by inviting comment from the many stakeholders directly and indirectly affected by and interested in it. We identify in this letter a number of issues that we believe were not fully explored by Congress during the legislative process or that have been revealed only after the passage of the Dodd-Frank Act more than two years ago. We believe that these considerations can serve as effective guideposts for congressional re-evaluation of the Volcker Rule as enacted.

In the second part of this letter, we suggest an alternative approach that would prohibit walled-off proprietary trading and rely on already higher capital requirements resulting from Basel III and other initiatives, rather than restrictions on certain activities.

In the third part of this letter, we highlight several structural elements and key provisions in the existing statutory text that present the most challenging obstacles to implementing appropriate limits on risk taking and potential conflicts while giving effect to congressional intent to permit banking entities to continue to provide the type of client-related financial services that did not contribute to the financial crisis and that are necessary for the efficient functioning of the global capital markets, financial system and economy. Among other things, we recommend that Congress reverse the presumption that all short-term principal trading is impermissible, and provide a targeted definition of "proprietary trading" and clear safe harbors.

I. Congress Should Re-evaluate the Volcker Rule as Enacted in Light of Its Impact on Market Liquidity, the Availability of Credit and Other Costs

We strongly believe that the Volcker Rule in its current form, and as proposed to be implemented by the regulators, will result in costs and other burdens on market participants, including institutional and retail investors, and the wider economy that Congress could not have intended, and will, in fact, increase the likelihood of financial instability. A recent report by the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness found that the Volcker Rule will have a significant negative effect on market making and liquidity provision for many securities, particularly in non-equity asset classes and securities where large and unexpected supply-demand shocks are more likely, thereby reducing liquidity in the very securities for which liquidity is most valuable.[3] In addition, the report stated that the Volcker Rule will make bank risk management less efficient. The report also found that the Volcker Rule is likely to lead to higher capital costs for businesses and an associated chilling effect on capital investments.

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[3] Center for Capital Markets Competitiveness, "The Economic Consequences of the Volcker Rule" (Summer 2012), *available at* http://www.uschamber.com/sites/default/files/reports/17612_CCMC%20Volcker%20Rule2.pdf.

A 2011 study by Oliver Wyman, commissioned by SIFMA, reached similar conclusions about the potentially significant negative consequences of the Volcker Rule, including higher funding and debt costs for U.S. companies, reduced ability of households to build wealth through participation in liquid, well-functioning securities markets, reduced access to credit for small or growing firms with less established credit ratings and histories, reduced willingness of investors to provide capital to businesses because of greater difficulties in exiting those investments, higher trading costs and consequently lower returns over time for investors, such as pension and mutual funds, and reduced ability for companies to transfer risks to others more willing and able to bear them via derivatives, with a consequent reduction in overall efficiency of the broader economy.[4] We note that the effect on pension funds and mutual funds will be felt by individual investors who will face lower returns on their investments from more limited investment opportunities as a result of reduced liquidity. Furthermore, limitations on market making may disproportionately affect smaller U.S. issuers relative to large multi-national corporations, as dealers may be less willing to take on risk associated with lesser known issuers.

In light of the risks to the economy, the agencies charged with implementing the Volcker Rule have responsibly proceeded in a very deliberate manner, although the pace of rulemaking has been extremely challenging for firms seeking to operate their businesses, and to make long-term strategic and investment decisions, in an environment of acute legal uncertainty. Following the agencies' issuance of proposed rules in November of 2011, more than 16,000 comment letters were submitted by U.S. and global market participants, foreign government agencies, lawmakers, public utilities and other end users, exchanges, think tanks, academics and other stakeholders. We believe that the fact that the agencies have been unable to agree on final rules nearly a year after the statutory deadline for final regulations should lead Congress to investigate whether implementation of the current statutory text is even possible.[5]

We would also draw congressional attention more generally to the criticisms expressed in comment letters by a wide variety of stakeholders. With these criticisms in mind, we suggest that Congress consider the following in its re-evaluation of the Volcker Rule as enacted:

- The costs of the Volcker Rule to the U.S. financial system, end users, investors, and the economy more generally.

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[4] Oliver Wyman, "The Volcker Rule: Considerations for implementation of proprietary trading regulations" (Oct. 2011), *available at* http://www.sifma.org/issues/item.aspx?id=22888.

[5] Although we respect the regulators' decision to proceed deliberately with implementation, we note that the statutory conformance period designed by Congress to ensure an orderly and non-disruptive transition has already begun in the absence of final rules. We urge that the conformance period be extended, regardless of the outcome of Congress's reevaluation of the Volcker Rule, in order to give effect to congressional intent to provide banking entities with appropriate time to conform to such an extensive new set of regulatory requirements on their businesses.

- The rationale for imposing the Volcker Rule on every affiliate of a bank, unlike the original Administration proposal and associated proposed legislative text issued by the Treasury, in which only insured depository institutions and their holding companies were made subject to the Volcker Rule. We recommend that Congress consider whether the Volcker Rule's unprecedentedly broad application of activities restrictions within a banking organization is necessary to achieve its goals.

- How the Volcker Rule can be structured in a way that does not imperil the traditional activities of banks and their affiliates that are not the target of the Volcker Rule.

- The extent to which the Volcker Rule could increase risks posed by the migration of previously regulated activities into unregulated quarters of the market.

- The impact that a unilateral U.S. application of the Volcker Rule will have on the position of the United States as the most innovative financial market in the world; on the competitiveness of the U.S. financial industry; on the willingness of foreign banking institutions to establish U.S. offices and participate in U.S.-based activities; on the role of the U.S. dollar as the world's reserve currency; and on borrowing costs of U.S. corporations.

II. Congress Should Rely on Already Proposed Capital Regulations Instead of the Volcker Rule's Activities Restrictions to Address Perceived Trading and Conflict Risks

One wholesale alternative to the Volcker Rule that we urge Congress to explore is reliance on already proposed capital rules and regulations that are under consideration and being implemented as a result of Basel III and other initiatives, rather than activities restrictions. This risk-based framework could be complemented by a prohibition on "walled-off" or "stand-alone" proprietary trading desks.

A risk-based framework with an effective supervisory overlay, under which higher capital charges, as a result of already proposed and existing rules, would apply to riskier activities as determined by the regulators, would be a more targeted and effective means of addressing the concerns underlying the Volcker Rule. Extensive prudential measures in the form of increased capital requirements are already being implemented globally, through the Basel 2.5 and Basel III reforms, which increase the existing capital requirements imposed on trading and funds activities. These additional capital requirements, including SIFI surcharges for large and complex financial firms, are complemented globally by the enhanced systemic supervision, credit exposure limits, stress testing and strengthened holding company requirements; in the United States, these are imposed by Title I of the Dodd-Frank Act. While the industry is working with the agencies to ensure that the proposed Basel III capital regulations are appropriately calibrated, we believe that

relying on these measures to appropriately restrict certain risk-taking would be at least as effective and far simpler to implement than the Volcker Rule's largely intent-based activities restrictions, particularly in the context of restricting activities in which the line between client-facilitative and proprietary activities can be so difficult to identify with precision. As Stanford professor Darrell Duffie noted in his study, commissioned by SIFMA, that he submitted as a comment letter on the proposed Volcker regulations, "[The] attempt to disentangle those trades that have market making intent from those that do not is likely to be effective only in reducing the capacity of market making services provided by banks. In addition, such an approach, having been adopted broadly across the globe, would avoid the competitive disadvantage that derives from imposing the Volcker Rule only in the United States.

Capital and liquidity requirements directly consider the soundness of a financial institution and its potential for causing systemic risk and costs to the Deposit Insurance Fund."[6] Under a risk-based approach, market makers would remain free to make qualitative judgments about the use of capital to facilitate customer activity in assets across the liquidity spectrum, but would be subject to limits that would curtail excessive risk-taking. Regulators could readily examine for compliance with this framework, and compare a trading unit's risk profile horizontally across banking entities. Related supervision of a banking entity's risk management framework, such as inventory, risk and position limits, would avoid the need for the type of trade-by-trade analysis of position-level data currently contemplated by the Volcker Rule, the supervisory impracticality and associated costs and compliance burdens of which have proven so difficult to implement. This would avoid the need to divert significant resources within both financial firms and regulatory bodies that would be better utilized for assessing risk and sound business practices.

III. If Congress Determines to Retain the Volcker Rule Framework as Enacted, It Should Make Major Modifications

Although we support a comprehensive re-evaluation of the Volcker Rule, including the risk-based approach discussed above, should Congress determine to retain the Volcker Rule framework as enacted, we believe that several modifications to the existing statute are necessary to achieve its goals without harming the ability of banking entities to continue to provide client-oriented financial services.[7] It is our hope that by identifying several of the most fundamental problems with the Volcker Rule, and recommending improvements, Congress will be alerted to

[6] Darrell Duffie, "Market Making Under the Proposed Volcker Rule" (Jan. 16, 2012), *available at* http://www.sec.gov/comments/s7-41-11/s74111-72.pdf.

[7] For the purposes of this letter, we have not made the type of specific language proposals that would be more appropriate at a later time once congressional fact-finding is more complete. We also do not repeat the many comments in our letters on the proposed implementing regulations, which letters can be found here.

the need for a substantial re-evaluation of the statutory text. We have included additional issues and recommendations in the appendix to this letter.

A. Congress Should Reverse the Presumption that All Short-Term Principal Trading is Impermissible, and Provide a Targeted Definition of "Proprietary Trading" and Clear Safe Harbors

First and foremost, we believe that Congress should reconsider the structural approach of the Volcker Rule's approach to proprietary trading and reverse the presumption that all short-term principal trading with the intent to profit from changes in short-term price movements, wherever located within a banking organization, is impermissible.

This negative presumption effectively casts a shadow on all of a banking entity's short-term principal trading activities, and puts an enormous burden on the regulators to define the scope of permitted activities in a way that avoids inadvertently prohibiting the client-oriented services that Congress intended to preserve through specific exemptions set forth in the statute. In other words, the broad definition of proprietary trading, combined with limited exemptions for certain permitted activities, causes all short-term principal trading activity to be suspect rather than targeting only the type of trading activities that Congress sought to prohibit. We believe that this approach is inconsistent with congressional intent to preserve useful principal trading activities and with the historical approach that the regulators have taken in supervising banking entities, and should be reversed. In our view, it has proven impossible to implement, and better structures for implementing Congressional intent are available.

As an alternative, we believe the structure of the statute should define proprietary trading to capture only the types of trading activities that Congress intended to restrict, that is, those that are not related to client-oriented financial services and that are intended to generate profit from short-term price movements for the banking entity (*i.e.,* the definition of proprietary trading should be revised so as not to be so broad as to capture *all* short-term principal trading, and should instead focus on walled-off proprietary trading and other short-term profit-motivated proprietary trading that is not undertaken for client-facilitation purposes). This definition should be narrower than the current definition of proprietary trading so that it does not cover the permitted activities, and therefore does not necessitate carve-outs. At the same time, we believe that the statute should designate clear safe harbors for market making, hedging, underwriting and other activities to avoid any possibility that the prohibition would extend to such vital activities. In this way, the activities covered by the safe harbor would not be subject to the backstop provisions relating to conflicts of interest and high-risk trading strategies and assets in the way that the activities are under the current statutory structure. Thus, banking entities would be able to engage in such permitted activities without fear that a good faith trade that complies with the terms of the safe harbor will be held to be a violation.

As part of this approach, banking entities would be required to adopt written policies and procedures with risk limits and controls, monitored through regulatory examinations. Banking entities that have substantial trading volumes would be required to report quantitative metrics. These metrics would not be used to prove that a banking entity is engaged in permissible trading, but instead would be reviewed by the regulators to confirm that banking entities are *not* engaged in prohibited trading. In other words, the metrics would provide regulators with a tool for monitoring for evasive activity. So long as a banking entity operated in good faith consistent with appropriate parameters established by the regulators, the banking entity could be confident that its activities were lawful. Changing the structure of the Volcker Rule in this way would address the conflict that the statute creates between what is prohibited and what is exempted, and that, incorrectly, led the regulators to propose rules that effectively include a rebuttable presumption that all principal short-term trading activities, including those expressly permitted by the statute, are prohibited. We believe that Congress should revise the structure of the statute to preclude such an outcome.

The consequences at stake in preserving the ability of banking entities to continue to engage in certain principal trading activities, particularly market making, cannot be exaggerated. Failing to do so will decrease liquidity, increase bid-ask spreads and price volatility and make it more difficult for issuers to raise funds in the primary markets and investors to sell their securities, thereby crippling capital formation and the ability of U.S. corporations to rely the capital markets to fund new investment projects and sustain employment. It will also result in higher costs of financing for homeowners and higher trading costs for pension funds and other investors. Furthermore, there is no reliable evidence that market participants that are not subject to the Volcker Rule (*e.g.,* non-bank-affiliated hedge funds and other entities not affiliated with banks) would be well-positioned to fill the void left if banking entities are prevented from intermediating the financial markets as they have traditionally done. Nor would the negative impact on liquidity, capital formation and financing be limited to the United States. As E.U. Internal Markets Commissioner Michel Barnier has observed, "[g]iven the absence of a clear delimitation between what constitutes banned proprietary trading and allowed market making, there is a real risk that banks impacted by the rule would also significantly reduce their market making activities, reducing liquidity in many markets both within and outside the United States."[8]

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[8] Letter from Michel Barnier, European Commissioner for Internal Market and Services, to the Agencies (Feb. 8, 2012). See also Letter from Office of the Superintendent of Financial Institutions Canada to the Agencies (Dec. 28, 2011) ("This is an especially acute concern for Canadian banks and the Canadian financial system more broadly given the deep inter-linkages that have existed for many decades between the Canadian and US financial systems. Canadian financial institutions use US-owned infrastructure to conduct financial transactions in support of their market-making activities in Canada . . . ."); Letter from UK Chancellor of the Exchequer George Osborne to Federal Reserve Chairman Ben Bernanke (Jan. 23, 2012) (The proposed Volcker regulations "could result in a reduction in market liquidity, leading to investors experiencing higher

B. The "Near-Term Demands" Condition of the Market-Making-Related Activities Exemption Should Be Eliminated

In conjunction with the structural change we recommend above, we believe that Congress should revisit certain of the statute's exemptions for permitted activities to ensure that they adequately preserve a banking entity's ability to engage in socially and economically useful client-oriented activities, such as market making. In other words, Congress should amend the exemption for market making-related activities to provide a clear safe harbor for such activities that is not constrained by the limitations that are imposed by the current statutory text.

A core problem with the market-making-related activities exemption in the existing statutory text is the requirement that the activity be "designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties." This restriction can be misapplied — and has been by the regulators in their proposed rules — to limit the ability of banking entities to accumulate inventory, thus materially frustrating their ability to make markets. We therefore recommend that Congress strike this condition entirely or explicitly provide that market makers may build and maintain appropriate inventory based on their experience and the exigencies of a particular market or asset class.

Much like a shopkeeper must accumulate inventory on her shelves to meet the demands of her customers, a market maker must maintain inventory to be able to meet the demands of its customers. However, like the shopkeeper who does not know what particular goods a customer will buy or when, the market maker does not always know what inventory a specific market participant will want or when. As such, a market maker must maintain a broad inventory of financial positions, with sufficient depth to meet unpredictable market demand. A market maker's process for maintaining appropriate inventory is also subject to an additional layer of complexity than that of a shopkeeper: the market maker must be prepared not only to sell a given financial position to a customer, but also to buy a given financial position from a customer. This is a crucial part of the market maker's intermediation function. To prepare to meet customer needs, the market maker may need to maintain short positions in various securities and/or sell its existing inventory to prepare it to take on positions customers wish to sell. In markets or asset classes in which trades are infrequent and customer demand is very hard to predict, it is unclear how a market maker would carry out its role if it were prohibited from building reasonable inventory.

At best, the "near-term" limitation injects uncertainty as to the legality of an activity that Congress intended to permit, and at worst the limitation may effectively prohibit banking entities from making markets in a wide variety of markets altogether. Therefore, to address this problem

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costs, delays, and potentially greater price volatility. Over the medium term, this may encourage a migration of market making to outside the regulated banking sector.").

and ensure that the regulators interpret the statute in a manner that honors congressional intent not to disturb banking entities' traditional market making role, we recommend that Congress remove the "near-term" limitation or explicitly provide that market makers may build and maintain appropriate inventory based on their experience and the exigencies of a particular market or asset class.

C. The Exemption for Risk-Mitigating Hedging Should Be Clarified So As Not to Limit Prudent Risk Management

We appreciate that Congress provided an exemption for risk-mitigating hedging. In doing so, Congress recognized, as expressed by the Financial Stability Oversight Counsel, that "prudent risk management is at the core of both institution-specific safety and soundness, as well as macroprudential and financial stability."[9] Hedging is also integral to facilitating customer trading activity; through hedging, banking entities can conduct their market making activities without being exposed to general price movements and can make loans to business and households without facing substantial interest rate risk. Thus, hedging plays a critical role in a banking entity's asset-liability, credit and business risk management functions.

To ensure that banking entities may continue to engage in the full scope of appropriate hedging activities, consistent with Congressional intent, we believe that Congress should amend the hedging exemption to provide a clearer safe harbor for hedging activity. For example, the hedging exemption could be revised to omit the requirement that the activity be designed to reduce "the specific risks" to the banking entity and instead refer generally to activity that is designed to reduce risks to the banking entity. Similarly, the requirement that the activity be in connection with or related to holdings of a banking entity could be eliminated so as to clarify that anticipatory hedging is permitted. Although we believe that the current statutory language is broad enough to encompass the hedging activities of banking entities, we believe that the statutory language contributed to the agencies' proposal to impose multiple conditions on the hedging exemption, which conditions would prevent, rather than encourage, legitimate and important risk-mitigating hedging activities. For example, whereas we believe that Congress intended to leave risk-mitigating hedging activities untouched by the Volcker Rule, the agencies proposed to implement the hedging exemption by requiring that hedging positions be "reasonably correlated" to the risk hedged and not create any "new significant risks at inception." We believe that the minor modifications that we suggest would provide more clear direction to the regulatory agencies to adopt rules that do not impinge on a banking entity's ability to manage prudently its risks.

[9] FSOC Report, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds 1 (Jan. 18, 2011) at 20.

We would also ask that Congress clarify that the hedging exemption applies to hedge funds and private equity funds to the same extent as it applies to proprietary trading, clearly allowing banking entities to structure, hedge and sell fund-linked investment products for customers, for example. Indeed, Congress should clarify that all permitted activities, including the underwriting and market-making-related activities permitted activities, apply with respect to hedge funds and private equity funds, just as they apply to proprietary trading.

D. The Definition of "Hedge Fund" and "Private Equity Fund" is Extremely Overbroad

The statute defines "hedge fund" and "private equity fund" extraordinarily broadly as any entity that relies on two exemptions in the Investment Company Act of 1940 that permit issuers to avoid the registration and other burdensome requirements imposed by that act on mutual funds.[10] Although these exemptions are relied upon by most hedge funds and private equity funds, they are also relied on by many other types of entities and corporate structures that have never been considered to be hedge funds or private equity funds – entities that simply do not have the core attributes generally associated with genuine hedge funds or private equity funds, such as, in the most obvious example, being a pooled investment vehicle. By defining "hedge fund" and "private equity fund" simply as any entity that relies on these exemptions, Congress imposed the full weight of the Volcker Rule's restrictions on banking entities' relationships with many wholly owned subsidiaries, acquisition vehicles, joint ventures, finance subsidiaries, regulated foreign funds, employee pension funds, and securitization and other financing vehicles, among others.

Several leading proponents of the Volcker Rule recognized that the definition was vastly overbroad, and in colloquies on the floor of the House and Senate expressed confidence that the regulators would correct the overbreadth of the statutory definition by granting exemptions for vehicles that are not properly treated as hedge funds or private equity funds.[11] However, congressional intent not expressed in the language of a statute is often accorded little weight by

[10] 12 U.S.C. § 1851(h)(2).

[11] *See, e.g.,* Colloquy among Senators Boxer (D-CA) and Dodd (D-CT), 156 CONG REC. S5870 (daily ed. July 15, 2010) ("In the event that properly conducted venture capital investment is excessively restricted by the provisions of section 619, I would expect the appropriate Federal regulators to exempt it using their authority under section 619(J)."); Colloquy among Representatives Himes (D-CT) and Frank (D-MA), 156 CONG REC. H5226 (daily ed. June 30, 2010) ("Because the bill uses the very broad Investment Company Act approach to define private equity and hedge funds, it could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds. I want to confirm that when firms own or control subsidiaries or joint ventures that are used to hold other investments, that the Volcker Rule won't deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings." "The point the gentleman makes is absolutely correct. We do not want these overdone. We don't want there to be excessive regulation. And the distinction the gentleman draws is very much in this bill, and we are confident that the regulators will appreciate that distinction, maintain it, and we will be there to make sure that they do.").

regulators or courts. Indeed, we understand that some of the regulators have expressed concern that the statute grants them narrow exemptive authority, particularly with respect to the definition of "hedge fund" and "private equity fund." As a result, there is a substantial risk that the final Volcker regulations could impose the restrictions that Congress intended to impose on banking entities' relationships and investments in genuine hedge funds and private equity funds on many types of other entities, with potentially far-reaching and destabilizing effects on the traditional, non-investment vehicle activities in which banking entities customarily engage.

i. The Funds Portion of the Volcker Rule Should Capture Only Hedge Funds that Engage in Proprietary Trading, Not Private Equity and Other Funds that Engage in Long-Term Investing

The central purpose of the Volcker Rule is to prohibit or limit banking entities from engaging in proprietary trading that is deemed to be too risky. The reason it was expanded to funds in the first place was to prevent banking entities from continuing to engage in proprietary trading by moving their proprietary trading operations into affiliated funds. But not all hedge funds engage in proprietary trading, and no private equity funds do. Private equity funds engage in long-term investing, buying and holding the debt and equity securities of portfolio companies; they do not engage in short-term trading of such securities. Therefore, the funds portion of the Volcker Rule is overbroad. To bring it into line with the central purpose of the statute, the funds portion of the Volcker Rule should be limited to hedge funds that engage in the same type of proprietary trading that is deemed to be too risky for banking entities to engage in directly.

ii. At a Minimum, the Volcker Rule Should Capture Only Entities That Have the Characteristics of Genuine "Hedge Funds" or "Private Equity Funds" As Commonly Understood

Should Congress determine not to distinguish between "hedge funds" and "private equity funds" as we have recommended, we believe that Congress should at a minimum address the overbreadth of the definition of those terms to capture only those entities that have the characteristics of a genuine hedge fund or private equity fund as commonly understood. To further ensure that congressional intent is honored, Congress should explicitly exclude certain entities from the definition of "hedge fund" and "private equity fund" that should never be deemed to be hedge funds or private equity funds, such as wholly-owned subsidiaries, registered investment companies, joint ventures, acquisition vehicles, finance subsidiaries, regulated foreign funds, employee pension funds, and securitization and other financing vehicles. The statute should also unambiguously provide that the regulators have the authority to exempt any other entity, as appropriate, such as lending and other credit funds.

E. The Volcker Rule Should Not Apply to All Affiliates of Insured Depository Institutions, In Keeping with the Administration's Original Proposal

Congress should also modify the definition of a "banking entity" subject to both the proprietary trading and funds portions of the Volcker Rule to include only insured depository institutions, companies that control an insured depository institution, and companies that are treated as bank holding companies for purpose of the Bank Holding Company Act, consistent with the original Volcker Rule as proposed by the Obama Administration and Treasury Department.[12] As described by the President in his January 2010 announcement, the Volcker Rule was intended to prevent firms from "benefit[ting] from taxpayer-insured deposits while making speculative investments . . ."[13] Protecting depositors has long been a central goal of U.S. banking regulation. Extending the Volcker Rule's reach to apply to every affiliate in a banking organization is unrelated to the goal of strengthening protection of depositors and reducing the likelihood that government support of those deposits would be occasioned by short-term principal trading losses.[14] It is also inconsistent with the limits on affiliate activities that banking entities have operated under for decades. Even under the Glass-Steagall regime, so-called "Section 20" affiliates of U.S. banks were permitted to underwrite and deal in debt and equity securities that insured banks could not underwrite or deal in directly, subject to certain revenue restrictions and prudential limitations.[15] Certain non-U.S. affiliates of U.S. banks could engage in an even wider range of activities.[16] Today, the limits on affiliate transactions between insured banks and their affiliates in Sections 23A and 23B of the Federal Reserve Act ensure that deposits cannot be put at material risk by affiliates. These limits, together with the activities restrictions on insured banks and their holding companies described in the original Volcker Rule proposal, would achieve the goal expressed by the President to protect depositors and taxpayers without unduly restricting the activities of affiliates. Similar logic, and a need to harmonize the

[12] "Amendment to the Bank Holding Company Act Regarding the Size of Institutions and the Scope of Bank Activities" (Mar. 3, 2010), *available at* http://www.treasury.gov/initiatives/Documents/amend.final.-3-3-10.pdf.

[13] "Remarks by the President on Financial Reform" (Jan. 21, 2010), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform.

[14] As many have pointed out, there is no evidence that such losses led to any taxpayer rescues of banking entities or otherwise contributed meaningfully to the financial crisis of 2008. Indeed, what many view to be the primary source of banking entity losses during that period — the buying and holding of securities backed by subprime and other low-quality mortgages — is not within the scope of the Volcker Rule at all, although many of the conditions that led to those losses have been addressed both by the industry and through regulation and supervision.

[15] David H. Carpenter and M. Maureen Murphy, Congressional Research Service, "Permissible Securities Activities Under the Glass-Steagall Act and the Gramm Leach Bliley Act" (Apr. 12, 2010).

[16] *Id.*

Volcker Rule with the rest of Dodd-Frank, supports providing that non-financial holding companies should not be considered part of a "banking entity," particularly if a banking entity creates an "Intermediate Holding Company" under Titles I or VI of Dodd-Frank to house its financial affiliates.

F. Congress Should Require a Cost-Benefit Analysis Before Any Implementing Regulations Are Issued or Finalized

We recommend that Congress require the agencies charged with implementing the Volcker Rule to conduct a rigorous cost-benefit analysis before issuing any regulations. Experience has shown that rigorous cost-benefit mandates result in more rational, efficient and transparent regulations that are more likely to reflect congressional intent. Congress should not be presumed to have intended to leave the agencies free to issue regulations that produce costs that substantially exceed their benefits.

IV. Conclusion

The far-reaching consequences of the Volcker Rule demand a thorough analysis of the costs and benefits of the current statutory text, the intended goals of the Volcker Rule, and potential alternatives to the Volcker Rule to better achieve those goals without triggering consequences that Congress did not intend. We believe that the many problems with the Volcker Rule identified by a wide variety of stakeholders also demonstrate the need for a substantive re-evaluation by Congress, and we strongly support the Chairman's initiative to do so.

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We thank the House Financial Services Committee and Chairman Bachus for their consideration of our comments. If you have any questions, please do not hesitate to call Kenneth E. Bentsen, Executive Vice President, Public Policy and Advocacy, SIFMA at 202-962-7400; Randolph C. Snook, Executive Vice President, SIFMA at 212-313-1114; our counsel, Margaret E. Tahyar, Davis Polk & Wardwell LLP, at 212-450-4379 and Randall D. Guynn, Davis Polk & Wardwell LLP, at 212-450-4239; or either of the organizations listed below.

Sincerely,

Securities Industry and Financial Markets Association

Financial Services Roundtable

Key Recommendations for Amending the Volcker Rule

Should Congress determine to retain the existing Volcker Rule framework, we recommend the following major modifications to the statutory text:

I. Proprietary Trading

A. Revise the structure of the statute to reverse the negative presumption by defining "proprietary trading" in a more targeted manner that is not so broad as to prohibit all principal positions taken for the purpose of selling in the near-term, such as for customer facilitation purposes. Provide clear safe harbors that banking entities can rely on in good faith.

B. Remove the requirement that market making and underwriting be designed "not to exceed the reasonably expected near-term demands of clients, customers or counterparties."

C. Clarify that the term "market making-related" is intended to permit banking entities to "maintain an appropriate dealer inventory and residual risk positions," consistent with Senator Bayh's statement in the colloquy between Senator Bayh and Chairman Dodd and Chairman Dodd's affirmation of such statement.[17]

D. Provide the same offshore exemption for U.S. banking entities as is provided for non-U.S. banking entities. Clarify that proprietary trading is permitted where the risk is held by an entity outside the United States, regardless of the location of related activities.

E. Expand the permitted activity for trading in U.S. government obligations to cover (i) state and municipal agency and authority obligations, (ii) obligations of foreign sovereigns, (iii) listed futures and options that facilitate liquidity in the underlying U.S. and foreign sovereign debt markets, and (iv) derivatives on permitted government obligations.

F. Designate traditional asset-liability management with appropriate safeguards as a permitted activity.

G. Clarify the scope of the hedging exemption so as not to limit the prudent risk-management activities conducted by banking entities.

II. Hedge Funds and Private Equity Funds

A. Revise the funds portion of the Volcker Rule to capture only hedge funds that engage in proprietary trading, not private equity and other funds that engage in long-term investing.

B. At a minimum, define "hedge fund" and "private equity fund" to capture only those entities with the characteristics of a hedge fund or private equity fund as commonly

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[17] 156 CONG. REC. S5902 (daily ed. July 15, 2010).

understood, excluding ordinary corporate structures that have never been considered hedge funds or private equity funds, such as wholly-owned subsidiaries, registered investment companies, joint ventures, acquisition vehicles, finance subsidiaries, regulated foreign funds, employee pension funds and securitization and other financing vehicles.

C. Eliminate the flat prohibition on covered transactions in "Super 23A" in favor of traditional quantitative and collateral 23A limits on covered transactions with related covered funds. At a minimum, permit the type of routine covered transactions that are not intended to create leverage or credit support or otherwise increase bailout risk.

D. Alternatively, clarify that the "Super 23A" affiliate restriction incorporates all the existing exemptions from "regular" 23A and its implementing rule, Regulation W.

E. Provide that all of the Volcker Rule's "permitted activities" exemptions from the Volcker Rule's general prohibitions, other than the asset management exemption, also serve as exemptions from Super 23A.

F. Asset management exemption

1. Clarify that a trustee without investment discretion will not be treated as a "sponsor."

2. Clarify that the 3% de minimis investment limits will not be construed to restrict the use of master-feeder, fund-of-fund or parallel fund structures.

3. Clarify that employee investments made prior to the issuance of final implementing rules are grandfathered.

4. In light of new capital requirements, eliminate the additional deduction from regulatory capital of investments made in covered funds held under the asset management exemption.

5. Clarify that extensions of the seeding period are available for both the per fund and aggregate 3% investment limits.

6. Clarify that the name-sharing condition applies only with respect to variants of the name of an insured depository institution or its ultimate parent holding company.

G. Provide a specific permitted activity exemption for sponsoring or investing in, and entering into covered transactions with related, credit funds.

H. Clarify that the underwriting and market-making-related activities permitted activities apply with respect to ownership interests in hedge funds and private equity funds, just as they apply to proprietary trading.

I. Clarify that the hedging exemption applies to hedge funds and private equity funds to the same extent as it applies to proprietary trading, and clearly allows banking entities to structure, hedge and sell fund-linked investment products for customers.

J. Provide the same offshore exemption for U.S. banking entities as is provided for non-U.S. banking entities. Clarify that sponsorship and ownership of, and transactions with, hedge funds and private equity funds is permissible where any related risk is held by an entity outside the United States, regardless of the location of related activities.

K. Clarify that the regulators should exercise appropriate discretion to provide for extensions for illiquid funds as appropriate based on all facts and circumstances, rather than in a narrow and inflexible set of circumstances.

III. General Recommendations Applicable to Both Proprietary Trading and Funds

A. Extend the two-year conformance period so that it begins after final rules implementing the Volcker Rule are issued, rather than July 21, 2012, in order to provide for the full two-year conformance period that Congress intended.

B. Define "banking entity" to include only insured depository institutions, companies that control an insured depository institution, and companies that are treated as bank holding companies for purpose of the Bank Holding Company Act, consistent with the original Volcker Rule as proposed by the Obama Administration and Treasury Department.

C. Provide the Board of Governors of the Federal Reserve System with exclusive authority to interpret the Volcker Rule and the final rules, rather than all five regulators jointly. Where more than one regulator has examination authority or enforcement authority over a given banking entity, require the regulators to engage in coordinated examination or enforcement for purposes of the Volcker Rule.

D. Require that the five regulators charged with implementing the Volcker Rule conduct a rigorous cost-benefit analysis before issuing final implementing regulations.

E. Provide the regulators with customary exemptive authority to ensure that when implementing the statute the regulators can effectively address any unintended consequences or absurd results that Congress did not intend.

F. Strike the material conflicts of interest / material exposure to high-risk assets or trading strategies backstop to ensure that banking entities can rely in good faith on safe harbors. Replace with the authority of the agencies to impose conditions or limitations on activities *ex ante*, as appropriate.

G. Clarify that extensions of the conformance period will be available for any genuinely illiquid fund holdings to the extent that such an extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest.