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February 10, 2012

The Honorable Ben S. Bernanke, Chairman
Board of Governors of the Federal Reserve System
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The Honorable Mary L. Schapiro, Chair
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

The Honorable John G. Walsh, Acting Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

The Honorable Martin J. Gruenberg, Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington; D.C. 20429

The Honorable Gary Gensler, Chair
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

With copy to:

The Honorable Timothy F. Geithner, Secretary of the Treasury
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

**RE: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in,
and Relationships With, Hedge Funds and Private Equity Funds¹**

Dear Sirs and Madam:

We appreciate the opportunity to comment on the notice of proposed rulemaking (“Proposed Rule”) to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Volcker Rule”), jointly released by The Office of the

¹ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011).

Comptroller of the Currency (“OCC”), The Federal Deposit Insurance Corporation (“FDIC”), The Securities and Exchange Commission (“SEC”), The Board of Governors of the Federal Reserve System (“Federal Reserve”), and later, separately by the Commodity Futures Trading Commission (“CFTC”)(collectively, the “Agencies”).

The Institute of International Finance, Inc. (“Institute” or “IIF”) is a global association of internationally active financial institutions from the U.S. and many other countries. The Institute has been consistently supportive of global efforts to update and reform financial regulation to reduce systemic risks and increase global financial stability. The Institute also promotes the development of strong risk management within firms in accordance with the goal of ensuring financial stability. We are writing to highlight a number of widely shared concerns about the Proposed Rule, including its implementation of the market-making related activities exception as well as the extraterritorial and international implications that may, as an unintended consequence, contribute to systemic risk.

Market-making related activities exemption

The Proposed Rule’s approach to delineating prohibited proprietary trading and permissible activities threatens to hinder, rather than advance, the stated purpose of improving financial stability. In particular, the Proposed Rule’s method of implementing the statute’s exemption for “market-making related activities” misconstrues the nature and function of market-making. As written, the Proposed Rule would not only result in an across-the-board decrease in liquidity and increase in price volatility in many markets in the U.S., but also have negative effects on markets globally, as banks will be forced to reduce the volume and quality of their market-making services if they have to comply with the exemption as currently drafted.

The proposed market-making related activities exemption, which is drawn more narrowly than the statute requires, overlooks the fact that market-making is fundamentally not separable from proprietary trading.² In order to fulfill its role, including providing market immediacy to clients, a market-maker needs to take principal positions in pursuit of that objective. This is an essential market activity which needs to be recognized as such and not caught up in the more general proscription designed to address proprietary trading. The Proposed Rule does not accurately reflect the essential characteristics of market-making because Appendix B, which applies to the market-making exemption, takes as its starting point a definition of the characteristics of proprietary trading that the Agencies will use to disqualify activities from that exemption.³ This leads to the inevitable conclusion that bona fide market-making activities will not be exempted because of their naturally shared characteristics with the prohibited activities. The Agencies should instead recognize market-making as a form of proprietary trading that would be permissible under the statute subject to an accurate and comprehensive definition of this economically essential function in terms of what it is, rather than what it is not.

² See DARRELL DUFFIE, MARKET MAKING UNDER THE PROPOSED VOLCKER RULE 3 (2012) (“The Agencies’ proposed implementation of the Volcker Rule seems to be written from the viewpoint that a trade involving significant risk of gain or loss, or taken with the objective of profiting from expected changes in market prices, is not consistent with bona fide market making.”).

³ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,961–63.

In addition to the many practical problems that would be caused by implementation of Appendix B, the rigid set of criteria banks must meet to qualify for the exemption in § __.4(b)⁴ appears to be based on an assumption that all market-makers deal in ultra-liquid asset classes such as exchange-traded equities in which they can be confident of unloading principal positions more or less instantaneously. In fact, many market-makers operate in highly fragmented and illiquid markets in which it is common for the market-maker to be exposed as a principal to any positions taken as a result of meeting the transactional needs of clients with immediacy. Although the Proposed Rule acknowledges that lower requirements should apply to market-makers dealing in less liquid markets,⁵ the structure of the rule still creates a negative presumption that banks may not engage in market-making unless they meet all of the listed criteria, including complying with Appendix B. The IIF suggests the Agencies abandon the negative-presumption approach, and instead create a positive presumption in favor of market-making so long as banks are satisfying liquidity needs in the relevant market.

In general, the Institute urges the Agencies to consider more closely the full business process implied by the broad term, “market-making related activities”, as used in the Volcker Rule, and avoid creating technical tests for specific aspects of those activities that would create impediments to banks’ carrying out effective market-making. These points regarding the market-making related activities exemption will be explained in extensive detail in the comments being supplied by the Securities Industry and Financial Markets Association (“SIFMA”) and others. We share SIFMA’s analysis of the shortcomings of the Proposed Rule with respect to this exemption. Moreover, the Agencies should take into account the negative consequences to financial stability and global capital markets if the final rule impedes the ability of banks to be fully effective because technical tests applied to specific parts of the process or specific transactions force them to curtail their market-making activities. Although it is clear that the Agencies considered many of these concerns in drafting the Proposed Rule, the Institute does not believe the proposed approach adequately addresses them.

The importance of the foregoing considerations cannot be stressed too highly. At a time when many markets around the world are fragile and face reduced liquidity, any measure, such as the Proposed Rule, that needlessly puts hurdles in the way of return to a state of sustained market health ought to be avoided. As drawn, the restrictions proposed fail to meet the statutory intent that banks ought to be able to continue to provide their historic function of robust market-making, and will most likely result in reduced overall liquidity, reduced market efficiency, and perhaps migration of some market-making activities to entities outside of the scope of prudential regulation (though it is hard to see at this point whether non-banks could offset substantial reductions in banks’ market-making capacity).

⁴ *Id.* at 68,947–48.

⁵ *E.g., Id.* at 68,871 (acknowledging that some of the “indicia” of market-making related activity cannot be applied equally to all asset classes or markets).

Extraterritorial burdens on non-U.S. banks, international issuers, and international markets

There are many problems with the Proposed Rule, the most fundamental of which is the misapprehension of the concept of market-making activities mentioned above. For this reason, we believe that the measure is misconceived and will require fundamental amendment to avoid highly detrimental effects in the U.S. There are also a number of specific and important problems that are of particular concern to the IIF's non-U.S. bank members. These are set out below alongside certain extraterritorial concerns of U.S. firms.

The extraterritorial challenges stem from the proposed interpretation of the international exemptions under the Proposed Rule. The Proposed Rule exempts foreign banking organizations (“FBOs”)⁶ from the proprietary trading restrictions if, among other requirements, their trading activities are conducted “solely outside of the United States.”⁷ Pursuant to the Proposed Rule, trading activities by FBOs will be considered solely outside of the United States if they meet four criteria: the trade must be executed wholly outside of the U.S.; no party to the trade is a resident of the U.S.; no personnel of the FBO entity who are directly involved in the purchase or sale are physically located in the U.S.; and the FBO conducting the purchase or sale is not organized under the laws of the United States.⁸ This interpretation of the solely outside the United States exemption is excessively narrow and fails to provide practical relief for most overseas proprietary transactions of large FBOs.

The Proposed Rule’s requirement that a trade be executed wholly outside of the U.S. is excessively narrow and will create difficult and largely unnecessary hurdles in global financial transactions.⁹ The Proposed Rule aims to ensure that a transaction that is executed relying on the exemption for foreign banking entities that engage in proprietary trading solely outside of the U.S. “does not involve . . . U.S. execution facilities.”¹⁰ Non-U.S. institutions execute various trades in the U.S. to take advantage of benefits such as time zones and the robust financial infrastructure and platforms that the United States’ capital markets provide. The use of U.S. trading platforms by non-U.S. institutions is incidental to proprietary and other kinds of trading and should therefore not be restricted. This criterion in the Proposed Rule would, for instance, restrict a foreign bank’s trading desk anywhere in the world from the purchase or sale for the account of the bank any security traded on a U.S. trading platform.

The Proposed Rule would therefore force issuers to dual-list in order to permit trading on non-U.S. exchanges, and clearing and settlement systems would have to set up new entities outside of the U.S. Such a highly literal interpretation of the statutory requirement contributes nothing to the achievement of the legislative purpose, but at the

⁶ 12 C.F.R. § 211.21(o) defines foreign banking organization to mean: “(1) A foreign bank, as defined in section 1(b)(7) of the IBA (12 U.S.C. 3101(7)), that: (i) Operates a branch, agency, or commercial lending company subsidiary in the United States; (ii) Controls a bank in the United States; or (iii) Controls an Edge corporation acquired after March 5, 1987; and (2) Any company of which the foreign bank is a subsidiary.”

⁷ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,949.

⁸ *Id.*

⁹ *See id.* at 68,882 (raising this issue in Questions 136–40).

¹⁰ *Id.* at 68,881.

least, it will create serious inefficiencies as well as operational risks and quite likely even systemic risks through adding needless complexity to the financial system. Applied when a trade does not involve any U.S. counterparties, the Proposed Rule would pose serious problems for foreign financial institutions and global markets, to no clear end.

As mentioned above, another of the criteria of exemption for a transaction from the Volcker Rule prohibitions is that “[n]o party to the purchase or sale is a resident of the United States.”¹¹ This provision has onerous extraterritorial effects in that an FBO would have to conduct extensive and otherwise unjustified additional due diligence on its counterparties’ origins, shareholdings, beneficiaries, locations, and intentions before being able to rely on the exemption. This approach extends the effects of U.S. regulations into foreign banks’ operations that will generally be fully compliant with the laws of other jurisdictions. Such an extraterritorial intrusion is unwarranted, given the stated intent and scope of the legislation. Furthermore, the definition of “Resident of the United States” as applied to counterparties is needlessly more expansive than the well-established meaning of a U.S. person set forth in the SEC’s Regulation S.¹² Such additional complexity unnecessarily raises compliance costs and increases operational risk.

The Proposed Rule subjects FBOs to complex recordkeeping and reporting requirements that are disproportionate and unwarranted for activities that occur outside the United States (and will be subject to local-market requirements). The rule also requires covered banking entities, including FBOs, that have consolidated trading assets and liabilities of more than \$1 billion to meet enhanced reporting requirements if they rely on certain permitted activity exemptions.¹³ The result of these requirements is an unprecedented extension of U.S. regulatory authority into foreign banking operations as well as many of their non-banking operations. It is also difficult to discern any rationale for extending the reporting obligations to the trading activities of non-financial entities. The Proposed Rule would require large FBOs conducting market-making operations or risk-mitigating hedging activities overseas to comply with substantial daily recordkeeping requirements and monthly reporting requirements to U.S. authorities.¹⁴

This intrusion into foreign banking activities does not advance the purposes for which the Volcker Rule was enacted; moreover it will work at cross-purposes with the extensive record-keeping and reporting requirements such FBOs already must meet for other domestic and international (including at times U.S.) regulatory purposes. Additional complexities of this type that are not well coordinated with other requirements are never helpful, but are all the more significant when, as the FSB and Senior Supervisors’ Group have pointed out, firms already need to make very extensive IT investments to improve internal risk management and implement regulatory and resolution reforms.¹⁵ Adding incremental requirements that do not contribute to well-integrated risk management adds to compliance and operational risk, complicating still further an already complex IT agenda,

¹¹ *Id.* at 68,949.

¹² SEC Regulation S, 17 C.F.R. § 230.902(k) (2011).

¹³ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,949.

¹⁴ *Id.* at 68,957.

¹⁵ FINANCIAL STABILITY BOARD, INTENSITY AND EFFECTIVENESS OF SIFI SUPERVISION: PROGRESS REPORT ON IMPLEMENTING THE RECOMMENDATIONS ON ENHANCED SUPERVISION (2011).

and may contribute to systemic risk.¹⁶ We therefore suggest the Agencies coordinate reporting and recordkeeping required of FBO non-U.S. activities with IOSCO and each FBO's home regulator, to avoid requirements that are inconsistent or duplicative, either as to substance, or as to technical details such as definitions and formats.

The Volcker Rule also prohibits a covered banking entity from investing in private equity and hedge funds. The technical and legal issues created by the Proposed Rule for U.S. firms will be discussed in the submissions of other associations. In this letter we wish to focus on some of the special concerns of extraterritoriality for other firms. The Proposed Rule limits the statutory exemption for FBOs' relationships with foreign hedge funds and private equity funds by an unnecessarily restrictive interpretation of "solely outside the United States."¹⁷ The Agencies have treated the "covered fund" concept so broadly in the non-U.S. fund context that the Proposed Rule will capture many investment funds that are not in fact covered funds, decreasing access for U.S. institutional investors to opportunities in specific asset classes and global markets. The loss of U.S. institutional investors in certain global markets will create adverse effects, especially for the liquidity of affected instruments. Requiring international banks seeking to invest from outside the U.S. to have certainty that no U.S. residents had been or would be offered or accepted by the funds would require assurances that no fund manager would likely be able to provide. The provision also appears to create an unwarranted competitive advantage for those foreign financial institutions that are not subject to the Volcker Rule because they have no substantial contacts with the U.S. and thus are not within the definition of foreign banking organization.

Further, FBOs that sponsor investment funds in accordance with the foreign funds exemption will not be able to use U.S.-based affiliates to find and communicate with non-U.S. investors (because "[n]o personnel . . . physically located in the United States" can take part in offering the fund).¹⁸ This would create operational difficulties for international banks that rely in some cases on U.S. institutions, platforms, and offices to facilitate certain operations.¹⁹ Here too, the Proposed Rule creates needless operational complexity and reduces efficiency with no very obvious connection to achieving the purposes of the legislation and, in this instance, is likely directly to reduce employment in the U.S. The effects will most likely extend well beyond the transactions envisioned in the Proposed Rule because firms may find it inefficient to continue to conduct other related business in the U.S. They may well find that it is more efficient to concentrate broader ranges of activities in foreign centers rather than undertake the compliance burden of sorting out those affected and those not affected by this portion of the Proposed Rule.

Extraterritorial burdens harming U.S. firms in global markets

Beyond the fundamental problems raised by its inappropriately narrow treatment of market-making, for their part, U.S. banks are concerned about competitive inconsistencies

¹⁶ INSTITUTE OF INTERNATIONAL FINANCE & MCKINSEY&COMPANY, RISK IT AND OPERATIONS: STRENGTHENING CAPABILITIES (2011).

¹⁷ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,953–54.

¹⁸ *Id.* at 68,949.

¹⁹ *See id.* at 68,911–12 (raising this issue in Questions 291–95).

that would arise from the Proposed Rule as currently formulated. It will circumscribe the ability of U.S. institutions to continue to play a major role in global financial markets and, as discussed above, will equally harm FBOs with U.S. operations. The restriction on U.S.-based institutions from engaging in proprietary trading outside of the U.S. will not only put U.S.-based institutions—and such FBOs—at a competitive disadvantage with respect to purely local firms but will greatly limit such institutions’ participation in these global financial markets at a time when restoring and deepening liquidity is essential to economic recovery—something which needs the continued participation of U.S.-based institutions and affected FBOs in particular.²⁰ This is true in well-established developed-world markets and particularly true in the most significant new domestic markets in other countries, such as Mexico, Brazil and Turkey, where there are great business opportunities and where participation by U.S. firms and affected FBOs can contribute significantly to the quality, professionalism, and depth of markets.

Additionally, U.S. covered banking entities as well as affected FBOs would likely retreat from permitted activities because the rules overall will have a limiting effect on the ability freely to engage in liquidity management and other core banking activities. As discussed above, a retreat from permitted activities, especially those related to market-making, by covered banking entities, would be a substantial loss to global financial markets.

Question 141 asks whether the Agencies should use their authority to allow U.S.-controlled banking entities to engage in certain proprietary trading activities outside of the United States.²¹ Where U.S. firms operate through locally incorporated and regulated subsidiaries outside of the U.S., the risks that the Volcker Rule is intended to address are substantially mitigated. In the interests of global liquidity and the historic role of U.S. financial institutions as leaders in the overall global financial system, the Proposed Rule ought to be structured so as not to restrict participation in foreign markets by U.S. firms outside the U.S. As proposed, the restrictions on foreign subsidiaries of U.S. firms would undermine, rather than promote, the safety and soundness of U.S. banking and, therefore, be detrimental to the financial stability of the international markets and thus of the United States.

Impacts on foreign markets, including foreign government bond markets

As discussed above, the most fundamental problem with the Proposed Rule is that its very narrow treatment of market-making related activities would have distortive effects on almost all markets. This is true of equities markets and various forms of public securities markets. The measure would have significant ramifications outside as well as inside the U.S.

From an international perspective, a further concern arises from the exemption of trades in U.S. government, agency, and municipal securities, but not corresponding foreign securities.²² This exemption is intended to, and will, help maintain the liquidity of U.S. government securities. However, as no such exemption is granted for other government

²⁰ The Agencies acknowledged this issue and their authority to correct it in Question 141 of the Proposed Rule. *See id.* at 68,882. (“Should the Agencies use the authority provided in section 13(d)(1)(J) of the BHC Act to allow U.S.-controlled banking entities to engage in proprietary trading . . .”).

²¹ *Id.*

²² *Id.* at 68,948.

securities, international banks with affiliations with U.S. entities will be forced to circumscribe and probably reduce trading in other foreign government securities, including those of their home governments and currencies. Such trading provides essential liquidity for such other government securities. In a period when there are concerns about many sovereign debt markets, an exemption confined to U.S. government securities would lead to unintended but severe negative consequences in global markets that could at least indirectly—but very substantially—affect U.S. banks and U.S. markets. Sovereign debt markets could be destabilized in a way that could create systemic concerns in financial markets, a situation the Volcker Rule was intended to avoid. Even if significant instability is avoided, it is in the interest of the long-term health of the global financial system, and of the United States and its financial institutions, to sustain the liquidity of all major sovereign debt markets, as a number of actions taken by the Federal Reserve during the crisis have illustrated. Creating barriers to participation in such markets by U.S. firms will be highly counterproductive. Putting impediments in the way of participation by FBOs will be even more damaging given the critical role of many such firms in sustaining the liquidity of their home markets and other major markets.

In response to Question 122, the Institute is of the view that it is essential to the fundamental safety and soundness of the U.S. as well as other financial institutions and to the financial stability of the United States—which is inextricably bound up with the stability of world markets—to broaden the exemption to include proprietary trading in the obligations of foreign governments. Section 13(d)(1)(J) of the Volcker Rule provides a statutory basis for the Agencies to do so. While all types of trading—including trading in U.S. government securities—entail risk, trading risks are best addressed by sound risk management, good internal governance, and strong supervision, all of which will be enhanced by the current FSB, Basel, and U.S. reform programs. The disadvantages the present proposal would create for global liquidity and the health of markets that are important in the broad scheme of things to the U.S. and the disadvantages created for U.S. firms cannot be justified in terms of the intrinsic risks in the markets concerned.

Existing and planned regulatory reform will address many of the concerns to which the measure is directed

An extensive program of global regulatory reform is under way. The Institute has been consistently supportive of international efforts to improve capital and liquidity requirements based on the relative risks of the activities involved. Consequently, the IIF has conducted ongoing constructive dialogue with the official sector to develop the effective and risk-based Basel III capital and liquidity buffers required to ensure the stability of the international financial system. The Institute has also contributed substantially to the dialogue conducted by the G20 and FSB on the definition and implementation of consistent and effective international standards across the board, including in the important area of cross-border resolution, all of which are key to reducing the instances and severity of failures of financial institutions. Further, the Institute has been fully engaged in efforts to promote enhancements of risk management within the industry. From an international perspective, we consider that an essential precursor to issuing a final rule should be review of the progress that has been made on international standards for the global financial services industry under the auspices of the G20 and FSB, with significant leadership from the U.S.

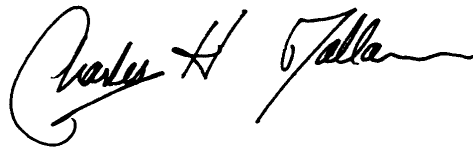
Authorities. The substantially augmented international regulatory regime that is being implemented addresses many of the risks that the Volcker Rule intends to prevent, provides the basis for consistent regulation around the world, and obviates any need for extensive extraterritorial interference with those global markets—something which is directly at odds with the globally consistent approach endorsed by the G20. Moreover, as already noted, such unnecessary extension of specific restrictions threatens not only to impede recovery but to detract from the potential depth and health of many global markets, and hence the financial well-being of the United States in a very direct way, for the foreseeable future.

The industry stands ready to discuss further the implications of the Proposed Rule on international markets. The Institute hopes that sound, robust, and competitive international markets based on the structure of standards now being put in place via coordination by the G20 and FSB would allow U.S. authorities to minimize the extraterritorial effects of the Proposed Rule.

We are sending a copy of this letter to the Financial Stability Board as the Institute considers that the issues raised here, particularly the impact on international markets, are of sufficient international import to merit consideration at the global level.

Best regards.

Sincerely,

A handwritten signature in black ink, reading "Charles H. Talla". The signature is written in a cursive style with a large, looping initial "C" and a long, sweeping tail.