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15 February 2012

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds—File No. S7-41-11

Dear Ms. Murphy:

CFA Institute[1] appreciates the opportunity to comment on the proposal (the "Proposal") of the Securities and Exchange Commission, the Department of the Treasury, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corp. (the "Regulators") to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), commonly known as the "Volcker Rule" (the "Rule"). This Proposal prohibits insured depository institutions from engaging in proprietary trading, with certain exceptions, and from having certain relationships with hedge funds and private equity funds.

CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the integrity and accountability of global financial markets.

[1] CFA Institute is a global, not-for-profit professional association of more than 108,000 investment analysts, advisers, portfolio managers, and other investment professionals in 139 countries, of whom nearly 99,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

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Executive Summary

CFA Institute supports the goal of the Rule. We interpret this goal as banning proprietary trading activities at depository institutions for the specific purpose of eliminating any potential for taxpayer support or use of insured deposits to back or otherwise fund proprietary trading operations. Moreover, this ban should be extended to any activities that are essentially proprietary trading in all but name.

To the extent that trading activities (market making) do occur within a bank holding company or similar institutional structure, it should be appropriately monitored and confined to separately capitalized, nonbank dealer subsidiaries of the bank's holding company. Even then, the potential systemic risk inherent in such operations is an important investor protection consideration and warrants full separation and segregation of these activities from those of insured depository institutions.

Cognizant of industry dissent asserting that the proposed Rule will create great uncertainty regarding market-making activities and the potential for serious liquidity disruptions, we encourage a closer look at these topics as the Rule is finalized. Our concern would be if these disruptions result in denied access to a range of fixed-income and other securities, having a serious negative effect on portfolio management, investor returns and market stability. We expect that Regulators will carefully consider the many definitional concerns related to differentiating proprietary trading and market-making activities, and clarifying the appropriate oversight and enforcement metrics for those players legitimately engaged in making markets for these instruments.

Finally, we support no further delay in adoption of the Rule, so as to reduce uncertainty about its provisions. At the same time, we support a careful approach to implementing the proposed regulations. This would include proper monitoring, gathering of data and assessment of the real-world effects of the Rule on bona fide market-making activities. If needed, we urge Regulators to act expeditiously to make changes or otherwise amend rules that are harming the normal functioning of the capital markets.

Discussion

We support the goal of the Rule to ensure that insured depository financial institutions do not take advantage of guaranteed deposits to fund proprietary trading. We support this goal for two primary reasons. First, we believe that permitting such activities would create moral hazard for banks by encouraging risk-taking under the recognition that the firms and their creditors could retain all gains from their risky trading endeavors while a taxpayer backstop would insulate them against losses. Second, this type of taxpayer backstop has given, and would continue to give, such institutions an unfair competitive advantage over trading firms that don't use insured deposits to fund their operations.

While the Rule in Dodd-Frank is both rigid and broad, the Proposal grants significant exemptions. The exceptions alone risk regulatory arbitrage and a regulatory framework that will be difficult to apply, monitor and enforce. For these reasons and as discussed below, we encourage changes as described below, together with careful implementation of the proposed regulations. We also encourage the Regulators to monitor how the rules are affecting the markets and make changes as needed to ensure properly functioning capital markets.

Another concern is that, as drafted, the Rule broadly defines a banking entity as:

> *"any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.S. 1813)), and company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity."*

The intention for this definition, as we understand it, is to ensure that banking institutions and their holding companies have limited flexibility to circumvent the prohibitions described in the Rule. This, in turn, would prevent such prohibited activities and reduce the potential for systemic failure resulting from the trading operations of depository institutions.

Because this provision is written into Dodd-Frank, we recognize that the Regulators have little latitude to change it in the Proposal. Nevertheless, we see the restraints written into section 619 for non-bank affiliates of bank holding companies as unnecessary so long as the parent company or any affiliate is prevented from accessing the insured funds of the depositories. Indeed, banking regulators in other markets such as Canada have long employed such a structure without adverse effect.

Likewise, we support the goal of preventing banks from using short-term, taxpayer-supported deposits to make long-term equity investments in companies through vehicles such as private equity funds. At the same time, we do not agree with the specifics of the Rule as written in Dodd-Frank with respect to restrictions on the private equity investments of non-bank subsidiaries of the holding companies. We believe such investments should be permitted so long as the investments are made by these non-bank subsidiaries and do not affect the capitalization and safety of the depository institution. Further, these types of investments should be permitted only if the non-bank subsidiaries are not permitted access to the capital or insured deposits of the banking subsidiaries.

The remainder of our comments will consider the issues raised in the Proposal and under the control of the Regulators.

Specific Issues

A. Effects on Liquidity

Besides the general concerns noted above, there are a number of specific provisions within the proposed rules that we believe will have negative implications for investors in illiquid investment markets.

The Proposal provides an exemption from its trading prohibitions for legitimate market-making activities. However, in the fixed-income market, in particular, distinguishing between proprietary trading and market making is difficult at best. It is in this market that our concerns are greatest about how the Proposal may affect important market-making activities.

The Rule, as written in Dodd-Frank, permits covered financial institutions to earn income solely from fees, commissions or bid/ask spreads from market-making activities. The Proposal specifically states that the rule was designed to ensure that revenues from market making are "not attributable to appreciation in the value of covered financial positions it holds in trading accounts or the hedging of such positions."

The realities of trading markets for instruments such as fixed-income securities are very different from the realities in the market for equity securities.[2] In illiquid markets, market participants do not benefit from a ready supply of buyers and sellers as is the case in large-cap equity markets. Under these circumstances, dealers cannot count on immediately finding buyers for securities purchased from selling customers as part of their market-making efforts. Nor can they count on finding

[2] For a thorough review of the differences between the market structures for fixed-income and equity securities, please see Chapter Three of our research report, "An Examination of Transparency in European Bond Markets," (Oct. 2011) available at http://www.cfapubs.org/toc/ccb/2011/2011/5.

securities that their clients may wish to purchase in the secondary market. Instead, dealers must act as principals and use their own capital to acquire such securities from selling customers and hold the securities in inventory until they locate investors interested in buying.

Under these circumstances, we are concerned that the Proposal, as drafted, will have negative effects on the bond market. These effects will be felt by mutual funds and retirement plans that are invested in bonds. A mutual fund that tries to liquidate holdings to meet redemptions may have difficulty selling at acceptable prices, thus impairing the fund's NAV for both redeeming investors and for those that remain in the fund. Likewise, a pension fund seeking to liquidate bond holdings to meet benefit requirements of plan participants may find that they need to liquidate more of their portfolio as a consequence of lower market prices.

It is for these reasons that in the short-term we urge the Regulators to move carefully in implementing the Proposal, to monitor its effects on the bond market, and to make changes if needed. For the longer-term, we encourage the Regulators and other thought leaders to consider a banking and regulatory structure that effectively and legally segregates depository institutions from the financial condition and performance of their holding companies and other holding company subsidiaries.

B. Extraterritorial Issues

Because debt instruments of foreign sovereign issuers are not exempt from the Rule's restrictions on proprietary trading, and because U.S. banks are important dealers in these instruments, we believe that the Proposal could reduce liquidity for these markets, as well. In particular, the strict provisions in the Proposal with regard to market making could reduce the willingness of U.S. dealers to make markets in all but U.S. sovereign debts, which could have detrimental effects for investors by limiting their ability to diversify globally.

We also believe that the approach taken in the Proposal with respect to "covered funds" would have extraterritorial effects. For example, the Proposal exempts certain interests and activities related to funds operating under the Investment Company Act of 1940 from the prohibitions against ownership of such funds. At the same time, it would impose a different standard for funds created and sold by banks under similar non-U.S. structures.

The lack of an exemption for similar investment vehicles offered by U.S. firms in other markets (e.g., Undertakings in Collective Investment Trust Securities, or UCITS in Europe) could hurt investors by limiting the investment and diversification options of U.S. investors. At the same time, foreign regulators with similarly regulated instruments may respond by prohibiting the sale of U.S.-registered fund products in their markets, thus impairing the investment options of investors in those markets.

We do not support treating U.S. and non-U.S. investment products differently if their structures substantially comply with U.S. laws. Instead we encourage revisions that recognize and treat domestic fund products and those from other markets in the same way so long as they both are regulated in a manner that is substantially similar to the way such funds are overseen in the United States.

Additional Suggested Improvements

As noted above, we would support a legal reorganization of bank holding company structures to ensure that any trading and investment activities, including market making, are conducted at a separate dealer subsidiary of a bank's holding company. This, together with effective regulation that controls how funds move between the depository and the holding company, in our view, has the potential to alleviate many of the concerns that the Rule seeks to address.

Beyond these concerns, we urge the Regulators to consider the changes suggested below to deal with the technical concerns described above. We believe that such changes will help address the underlying issues of proprietary trading in a simpler and more workable manner.

First, we urge the Regulators to clearly define in final rules what constitutes market-making earnings and the process and timing over which such earnings are generated so that dealers' market-making activities in illiquid securities can function as close to normal as possible. Clearer definitions should give dealers assurance that expenditures for monitoring or defending against enforcement actions by the Regulators for legitimate market making will be manageable.

Finally, due to the complexity of the Rule and the Proposal and due to concerns about the potential for unintended consequences, we urge the Regulators to adopt a careful approach to implementation of the Rule. Following implementation, we urge the Regulators to monitor closely how markets for fixed-income securities, in particular, are adapting to the rules, and to make changes quickly if the effects are significantly negative.

Conclusion

We appreciate the opportunity to comment on the Proposal to implement the Volcker Rule. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or James C. Allen, CFA at james.allen@cfainstitute.org or 434.951.5558.

Sincerely,

/s/ Kurt N. Schacht

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