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February 17, 2012

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1432
RIN 7100 AD

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 20429
RIN 3064-AD85

Office of the Comptroller of the Currency
250 E Street, SW.
Mail Stop 2-3
Washington, DC 20219
Docket ID OCC–2011–14
RIN 1557-AD44

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE.
Washington, DC 20549–1090
File Number S7-41-11
RIN 3235-AL07

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

Ladies and Gentlemen:

We appreciate the opportunity to comment on this important proposal. I have attached a more detailed letter, but I wanted to emphasize my broader concerns regarding this important regulation.

I am CEO of UBS Americas and CEO of UBS Wealth Management Americas. UBS is one of the largest wealth managers in the world and also a global asset manager and global investment bank.

While UBS and I share the aspirations behind the Volcker Rule to control systemic risks to our financial system, it is important for the Agencies to strike a better balance between prohibiting transactions outlined in the Dodd-Frank Act and allowing the free market to work on behalf of investors. Prohibiting harmful transactions is important, but the Agencies are also charged with drafting regulations that ensure vibrant and liquid markets so that investors continue to have access to a broad range of transactions and products. We believe that while the Agencies are working to protect investors from systemic risk, they also should pay close attention to the consequences for investors and issuers if the regulations cause adverse impacts on well-functioning capital markets.

As currently constructed, the rule could create a number of unintended consequences that hurt investors and companies. Our comments focus on some of the practical problems our bank already sees coming with such a broad-ranging prohibition. Some are impacts on the financial services industry, but in the end the impacts will also be felt by individual investors. In particular, the rule has the potential to make it harder for American businesses and

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municipalities to raise capital and have access to credit. As the U.S. continues its long recovery from the financial crisis, I hope you will keep this in mind.

We expect that there are a number of consequences we cannot currently foresee. The regulatory benefits should not be outweighed by the burden on capital formation and investor choice.

Again, we understand the difficulty of the task at hand for the Agencies and we are committed to engaging as a constructive partner in this important rulemaking process.

Very Truly Yours,

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

Ladies and Gentlemen:

We respectfully submit these comments on behalf of UBS AG ("UBS") in response to the request for comment on the proposed rules implementing the Volcker Rule.[1] While we agree with the broad intent and policy goals of the Volcker Rule and appreciate the great deal of work that has already gone into implementation of that rule, we have numerous concerns with the Agencies'[2] Proposed Rulemaking, as currently drafted.

The Proposed Rulemaking will require tremendous changes in the organization, infrastructure, and trading activity of banking entities, including ours. While we have begun to mobilize the resources necessary for those changes, because so many aspects of the Proposed Rulemaking are largely unworkable or uncertain, we are hesitant to make additional substantial investments. Indeed, we believe that a number of important modifications must be made to the Proposed Rulemaking to ensure a final rule that will result in an effective Volcker Rule compliance regime that is workable both for banking entities and for the Agencies. Our

[1] Request for Public Comment on Notice of Proposed Rulemaking Implementing the Provisions of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Concerning Restrictions on Proprietary Trading and Certain Interests in and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011) ("Proposed Rulemaking"). References to the "Volcker Rule" in this letter refer to Section 619 of the Dodd-Frank Act, which added new Section 13 to the Bank Holding Company Act of 1956 ("BHC Act").
[2] The "Agencies" are the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC).

specific recommendations are summarized below, followed by a discussion that offers our perspective as an internationally-active bank with a sizable U.S. presence that we hope will be useful to the Agencies.

Summary of Recommendations

Part I: Concerns Related to the Prohibition on Proprietary Trading

I.A Trading Activity "Outside of the U.S."

- We recommend modifying the exemption in the Proposed Rulemaking for trading "solely outside the U.S." to minimize the impact on non-U.S. activities and markets and suggest that the extraterritorial reach of the Proposed Rulemaking should more generally be the subject of discussion within international regulatory forums.

I.B Trading in Non-U.S. Government Obligations

- The exemption for trading in U.S. government obligations should be expanded to cover trading in non-U.S. government obligations.

I.C Risk Management Instruments for U.S. Governments, Foreign Exchange, and Commodities

- In order to allow banking entities to appropriately manage risk, we recommend expanding the exemption for trading in U.S. government obligations contained in § ___.6(a) of the Proposed Rulemaking to include trading in futures and options on futures in U.S. government securities.

- Similarly, we recommend that, when done in connection with spot foreign exchange and spot commodities, transacting in forwards and options in foreign exchange and commodities should generally receive the same treatment as spot transactions so that trading desks do not need to segregate their activity to the detriment of sound risk management.

I.D Municipal Securities

- We recommend that the Agencies modify the definition of "municipal securities" to incorporate the full definition of "municipal securities" contained in Securities Exchange Act Sec 3(a)(29).

I.E Transactions for Funding Purposes

- We recommend exempting from the Proposed Rule those transactions by a banking entity that are fundamentally for the purpose of funding or asset-liability management in which the banking entity takes title to financial instruments, provided that such transactions can be demonstrated to result in economic and risk characteristics that are substantively the same as those of repo or reverse repo transactions.

I.F Quantitative Measurements

- In general, we believe that the proposed metrics are too prescriptive and do not permit enough flexibility. We recommend early and continual dialogue between covered entities and the Agencies, and urge the full use of the conformance period for establishing and refining these metrics.

- Spread Profit and Loss (P&L) & Pay-to-Receive Spread Ratio: We urge the Agencies to expand the flexibility offered in choosing a bid-offer source to the entire process of calculating Spread P&L, and recommend that the Agencies adopt a similar expectation for alternative calculations for the Pay-to-Receive Spread Ratio.

- VaR Exceedance: We recommend this metric be withdrawn.

- Customer-Facing Trade Ratio: We recommend comparing a factor that measures the most material risk, as opposed to trade count.

- Inventory Risk Turnover & Inventory Aging: We recommend that the Agencies rethink these metrics to account for the heterogeneous nature of trading units.

Part II: Concerns Related to Investments in and Sponsorship of Covered Funds

II.A Permitted Market Making for Covered Funds Activities

- We ask that the market-making and underwriting exemptions be expressly included in § __.13 of the Proposed Rulemaking.

II.B Concerns for Banks' Global Asset Management Businesses

- Inclusion of 'Foreign Equivalent' Covered Funds: We recommend that the Proposed Rulemaking be revised to explicitly exclude foreign equivalent funds and non-U.S. regulated funds from the definition of covered fund.

- Definition of "Banking Entity": We recommend that non-U.S. regulated funds and similar entities be explicitly excluded from treatment as a banking entity.

- Definition of U.S. Resident: We recommend that the Proposed Rulemaking's definition of "resident of the United States" conform to concepts found in the SEC's Regulation S.

- Super 23A: We recommend that the Super 23A limitations not be applied to banking entities and covered funds that rely on the foreign fund exemption.

- Sharing a Name between a Banking Entity and a Covered Fund: We recommend that the name-sharing prohibition not be applied to covered funds that rely on the foreign fund exemption, as amended.

II.C Employee Benefit Plans / Compensation Issues

- Employee Benefit Plans: We recommend that the final rule explicitly provide that the Volcker Rule does not prohibit the acquisition or retention of an ownership interest in a covered fund by the employee benefit plans of a banking entity if such interest is held or controlled through a trust, insurance contract, or other trust-like vehicle (i.e., where the banking entity is not acquiring or retaining the interest directly or indirectly as principal), regardless of whether such plans are U.S. tax-qualified plans.

- Extraterritorial Reach with Respect to Employee Benefit Plans / Compensation: We note that adopting a definition of "resident of the United States" that mirrors the definition in the SEC's Regulation S (including the explicit exclusions in Regulation S such as the employee benefit plan exclusion) would eliminate some, if not all, of the concerns for banking entities that employ international assignees.

Discussion

Part I: Concerns Related to the Prohibition on Proprietary Trading

I.A Trading Activity "Outside of the U.S."

The Volcker Rule permits "trading occur[ring] solely outside the U.S." The Proposed Rulemaking, however, goes much further than necessary to implement the terms and intent of the statute by prohibiting proprietary trading with a U.S. counterparty, through a U.S. agent, or on a U.S. exchange even when that proprietary trading activity occurs solely outside of the U.S. The approach taken by the Proposed Rulemaking would have major implications for the non-U.S.-based activities of international banks globally, which are not, in our view, justified on safety and soundness grounds in relation to U.S. markets. Moreover, without sufficient discussion and coordination with non-U.S. regulatory authorities, this extraterritorial reach threatens to undermine the framework for global regulatory cooperation which is clearly critical to the overall reduction of systemic risk in financial markets.

The Proposed Rulemaking would significantly narrow the "solely outside the United States" ("SOTUS")[3] exemption for proprietary trading by foreign banking organizations. For markets characterized by bilateral over-the-counter interactions, including many bond markets around the world, foreign banking organizations with U.S. operations will almost certainly need to adopt a Volcker Rule compliance regime for those activities. For example, UBS would need to develop such a regime to ensure compliance with the Proposed Rulemaking for its trading in Swiss bonds (government or corporate) conducted in Switzerland, as long as there is the possibility that one of its counterparties was a U.S. institution.

Adoption of such a narrow exemption, which would have broad effects on non-U.S. markets, would effectively substitute the judgment of U.S. authorities for those of their fellow supervisory authorities in non-U.S. jurisdictions, many of which have chosen to address systemic and prudential concerns largely through enhanced liquidity and capital standards, and possibly through legal entity restrictions[4]. Given these international prudential choices – including in some cases embracing prudential standards that exceed international standards, such as Switzerland's approach to capital standards – the Agencies would be hard-pressed to assert a prudential justification for their proposed imposition of proprietary trading restrictions to activities conducted by non-U.S. banking organizations outside the U.S. At the very least, if prudential concerns are the underlying rationale, they merit open discussion within international regulatory forums.

In fact, in our view, a narrow SOTUS exemption risks undermining global financial regulatory cooperation, which could have multiple negative consequences, including a weakening of the aggregate global response to systemic risk. In addition, it is conceivable that market

[3] § ___.6(d) of the Proposed Rulemaking: "Permitted trading outside of the United States."
[4] The Final Report from the U.K.'s Independent Commission on Banking recommends a retail ring-fence for banks.

participants would adjust to this development over the long term by effectively segregating U.S. firms. In other words, there is potential that non-U.S. market participants would need to establish procedures to ensure that one set of trading and settlement activities could only occur without U.S. firms being involved, while another more expensive and onerous set of activities would permit the involvement of U.S. firms. Such a bifurcated approach would add substantial costs to dealing with U.S. institutions as well as non-U.S. banks with a U.S. presence, and would reduce liquidity and ultimately be counter-productive to the competitive standing of such institutions.

In summary, we believe the approach embodied in the current narrow SOTUS exemption is not justified by the language of the statute or on prudential grounds. Worse, applying the Proposed Rulemaking to foreign institutions could introduce unintended consequences. The Proposed Rulemaking poses a serious risk to the framework of global financial regulation, as demonstrated by the unprecedented number and tone of comment letters already filed by foreign financial authorities[5].

I.B Trading in Non-U.S. Government Obligations

The Proposed Rulemaking exempts trading in U.S. government obligations from the prohibition on proprietary trading subject to certain compliance requirements. Proprietary trading in non-U.S. government securities, however, is not exempt from the prohibition and may only be conducted if another exemption applies, such as market making. Because the compliance requirements for trading in U.S. government obligations are substantially less burdensome than those for market making activities,[6] trading in non-U.S. government securities would be far more complicated and expensive than trading in their U.S. counterpart. This discrepant treatment could introduce both actual and perceived limitations on a dealer's ability or willingness to hold positions in non-U.S. government securities. Such limitations, whether perceived or actual, could easily lead to reduced liquidity with a corresponding adverse impact on the success of future auctions.

To comply with the Volcker Rule, trading in U.S. government obligations requires the production of only five metrics, all of which are already consistent with traditional risk management. It is unlikely, therefore, that market participants would materially change their involvement in this market. Requiring, however, that banking entities follow the more burdensome requirements in connection with non-U.S. government obligations, including the calculation of all seventeen metrics along with the associated controls, could reasonably cause a number of participants in non-U.S. government bonds to back away from market involvement leading to less liquidity.

We therefore recommend that trading in non-U.S. government securities receive the same treatment under the Proposed Rulemaking as trading in U.S. government obligations. If the Agencies decline to exempt all non-U.S. government securities from the prohibition on proprietary trading, then, at a minimum, we would ask that trading in non-U.S. government securities be exempted in the following instances: (i) for all institutions, trading in the government securities of any OECD-member country, (ii) trading by an institution (and all its affiliates) in its home country's government securities, and (iii) trading by an institution in its host country's government securities.

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[5] *See, e.g.,* Letters from: EU Commissioner Michel Barnier (February 8, 2012), UK Chancellor of the Exchequer George Osborne (January 23, 2012), The Bank of Japan and Financial Services Agency (December 28, 2011), and the Office of the Superintendent of Financial Institutions Canada (December 28, 2011).

[6] The "market making exemption" refers to the scope of activities outlined in § ___.4(b) of the Proposed Rulemaking.

In addition, for the same reasons discussed below in Section I.C., if the Agencies do exempt non-U.S. government securities from the prohibition on proprietary trading, we would ask that futures and options on futures in non-U.S. government securities also be exempted.

I.C Risk Management Instruments for U.S. Governments, Foreign Exchange, and Commodities

As mentioned above, banking entities have already begun dedicating substantial resources to aligning their businesses with the requirements of the Proposed Rulemaking. However, we are particularly concerned about the operational and risk-management separation that would be required for trading desks that are engaged in markets for U.S. government securities, foreign exchange, or commodities.

Under the Proposed Rulemaking, the prohibition on proprietary trading does not apply to trading in U.S. government obligations. Similarly, both spot foreign exchange and spot commodities are exempt from the definition of "covered financial position," and thus trading in these instruments is also not subject to the prohibition on proprietary trading. Banking entities that engage in these markets, however, transact in "vanilla" derivatives, such as futures, forwards, and options, on the underlying exempted product as part of overall risk management for the trading desk. Requiring banking entities to segregate trading in these related instruments for purposes of complying with the Proposed Rulemaking would be fundamentally inconsistent with the corresponding business organization and work flow, and impede effective risk management related to customer activity.

i. <u>Futures and Options on Futures for U.S. Government Securities</u>

Banking entities' trading businesses in U.S. government securities rely upon continual quoting of prices and execution of transactions and require that traders choose from several acceptable choices in the market to minimize risk. Frequently, this involves the use of futures and options on futures, in addition to U.S. government securities, to provide the greatest flexibility in managing risk. By excluding futures and options on futures on U.S. government securities from the scope of the exemption from prohibited proprietary trading, a trader must create an operational separation in processing trades. Worse, the trader must separately monitor and possibly limit the incremental risk taken on through using these risk-managing instruments in order to qualify for the Permitted Risk-Mitigating Hedging exemption[7].

The Agencies' own Question 121 reflects the potential for concern around this bifurcated structure. Any perceived limitation that a trader might have about its ability to hedge exposures and manage risk in an optimal fashion will likely have an adverse impact on its willingness to hold risk in the underlying product through the course of a trading day. Such a view would likely impact pricing in U.S. government, agency, and municipal obligations, affecting execution for all investors and likely impacting their ability to participate in auctions to the same degree that they do now. Expanding the exemption for trading in U.S. government obligations contained in § ___.6(a) of the Proposed Rulemaking to include futures and options on futures on U.S. government securities would mitigate operational impact, permit existing risk management to continue unencumbered, and prevent liquidity reduction. Yet, this activity would remain within the required metric-based supervision framework for trading in U.S. government obligations.

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[7] "Permitted Risk-Mitigating Hedging" activity refers to § ___.5 of the Proposed Rulemaking.

ii. Forwards and Options for Foreign Exchange and Commodities

Banking entities' foreign exchange and commodities businesses similarly rely upon spot exchange, forward exchange, and options for managing risk. By exempting only activity involving a spot exchange, the Proposed Rulemaking mandates that market makers clearly segregate these interrelated types of activity and conduct metric-driven monitoring of one facet of the business while having no such obligation with respect to the other. Because both customers and market makers generally assess a portfolio of trades on the basis of their material risks, this segregated structure would be inconsistent with the effective functioning of these businesses. While forward transactions explicitly introduce interest rate and/or leasing risk to the core spot risk, this spot risk greatly outweighs the interest rate risk[8]. For that reason, market makers that manage these types of trades together can provide tight pricing to customers because they have the ability to lay off the dominant spot risk through either spot or forward transactions.

We therefore recommend that, when done in connection with spot foreign exchange and spot commodities, transacting in forwards and options should receive the same treatment as spot transactions so that trading desks do not need to segregate their activity to the detriment of sound risk management. For forwards, we believe that a workable solution would be to exempt a limited duration forward – for example 30 days – where the spot risk is more material. This limited expansion of the exemption would allow the spot trading desks to continue to manage risk effectively and appropriately.

I.D Municipal Securities

We believe that, as currently written, the Proposed Rulemaking construes the term "government obligation" inappropriately narrowly and would divide the current world of municipal securities into two classes: those that are subject to the prohibition on proprietary trading absent an exemption such as market making, and those that are not subject to the prohibition.[9] Specifically, the Proposed Rulemaking construes the concept of a "political subdivision" to exclude state, city, and county agency and authority-issued debt from "government securities." This narrow interpretation is not called for by the statute. Moreover, it runs counter to the practice of the municipal securities marketplace and its governing regulatory scheme. Failure to expand the definition of municipal security in the Proposed Rulemaking will therefore result in inconsistency and confusion. It will also likely raise the cost of borrowing for state agencies and authorities and is likely to have unintended adverse effects on investors.

We believe it may be helpful to consider an example, such as the New York State Thruway Authority,[10] whose securities would not qualify for an exemption as "municipal securities"

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[8] By way of an example, the stand alone Value at Risk (VaR) exposure from the foreign exchange component of a 30 day USD/EUR forward would be approximately 50 times greater than the associated interest rate risk. Holding for most foreign exchange pairs (typically between 40 to 60 times greater), this ratio logically concludes that the risk management of such forwards be joined with that of the spot transactions.

[9] Section § __.6(a) of the proposed rule permits the purchase or sale of a covered financial position that is: (i) an obligation of the United States or any agency thereof; (ii) an obligation, participation, or other instrument of or issued by [a number of government-sponsored enterprises]; or (iii) an obligation issued by any State or any political subdivision thereof. The Agencies interpret "political subdivision" narrowly and state: "Consistent with the statutory language, the proposed rule does not extend the government obligations exemption to transactions in obligations of an *agency* of any State or political subdivision thereof." Proposed Rulemaking, note 165 (Emphasis added.)

[10] As described in a 2009 offering document: "[t]he Authority, a body corporate and politic constituting a public corporation, created in 1950 by the [New York State Thruway] Act, is empowered, among other things, to construct, operate and maintain as a toll facility, and to improve and reconstruct the New York

under the Proposed Rulemaking, but which are treated as municipal securities under existing law and regulation. Thus, these bonds are not required to be registered with the SEC under the Securities Act of 1933 (the "Act"), since Section 3(a)(2) of the Act exempts "[a]ny security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories…" They are, however, subject to SEC Rule 15c2-12, which governs continuing disclosure for municipal securities.[11] The rules of the Municipal Securities Rulemaking Board govern broker-dealer transactions and reporting for these Thruway securities. Moreover, FINRA rules applicable to non-municipal debt securities are not applicable to the securities of this issuer because they are considered municipal debt securities. Finally, the Government Accounting Standards Board considers the Thruway Authority a "component unit of the State of New York," even though the bonds are not a debt of the State itself.

There are thousands of individual investors who purchased this one bond issue, either directly or indirectly as part of a portfolio of exchange-traded funds or municipal mutual funds that hold these Thruway bonds. Those investors bought their bonds or fund shares presumably expecting that these state agency bonds would be traded and valued by a municipal marketplace that would accord them the same treatment as other municipal bonds. However, under the Proposed Rulemaking, the Thruway bonds, and indeed a large percentage[12] of the existing outstanding municipal securities, will not be able to rely on the exemption for government securities.

If one multiplies the thousands of individual investors who directly or indirectly own this single issue of Thruway bonds by the thousands of issues of such agency/authority bonds that have occurred over the past twenty to thirty years throughout the United States, it is easy to see that millions of investors risk being significantly disadvantaged by the Proposed Rulemaking. As drafted, the Proposed Rulemaking is likely to lead to a smaller group of municipal market participants for these securities and as a result, is likely to cause a significant decline in liquidity and resulting market value for these non-exempt issues. We do not believe this is the Agencies' intent.

We also do not believe it is the Agencies' intent to raise the cost of borrowing for state agencies and authorities, which is likely to occur because the marketplace will "charge" higher interest rates to issuers selling less-liquid debt. Yet these agencies are key players in the infrastructure at the state and local level. For example, state university dormitory construction, state and county roads and bridges, state-administered multi-family housing, and critical ongoing water conservation and environmental protection projects are all frequently funded by securities issued by agencies, not the state, county, or city itself. The impact of adding greater stress to the budgeting and expenditure process for such activities will be felt directly by the state and local employees of these agencies and by every citizen

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State Thruway (the "Thruway"), subject to certain statutory limitations on the Authority's right to impose tolls on certain parts of the Thruway, including I-84 and the Cross-Westchester Expressway. The Act provides that the Authority shall continue its corporate existence and operate and maintain the Thruway so long as it shall have bonds or other obligations outstanding and until its existence shall be terminated by law. Upon termination of the existence of the Authority, all its rights and properties shall pass to the State of New York (the 'State"). The Act authorizes the Authority to issue, from time to time, negotiable bonds and notes for any corporate purposes, secured by tolls, revenues, rates, fees, charges, rents and other earned income of the Authority. (see New York State Thruway Authority, General Bond Anticipation Notes, Series 2009A, page 1.)" This description clearly reflects the Authority's status as an integral part of State operations.

[11] Securities Exchange Act Rule 15c2-12.

[12] Please note that the 2011 MSRB Annual Report reflects that 45.1% of securities issued in 2011 were issued by state or local agencies.

who currently pays, among other things, college housing costs, travel tolls, or ordinary water supply fees. In addition, service levels may decline. These agency-bond-funded activities are the exact kinds of infrastructure projects that are most suited to administration and delivery at the local level. A needless bifurcation of municipal securities' trading characteristics under the Proposed Rulemaking would make these typical and traditional public benefit activities more difficult and more expensive, at a time when budgets are already strained. Adding additional expense for these agencies will in turn significantly adversely affect the public.

While governments could respond to the Proposed Rulemaking by converting existing agencies into direct divisions of the relevant government, any such action would be expensive and time-consuming and would require considerable legislative effort. Moreover, its ultimate impact on investors would be negative because it would reduce the diversity of municipally-issued securities. For individual investors, the ability to purchase highly rated, specific-stream-of-revenue-secured agency bonds (with generally more detailed disclosure about that revenue stream) would diminish. Investors would be exposed to more state-issued debt, with potentially lower credit quality.

We therefore urge the Agencies to try to avoid the consequences that we believe will likely flow from the narrow construction of "political subdivision," and ask that the Proposed Rulemaking be modified to incorporate the full definition of municipal securities contained in the Securities Exchange Act Sec 3(a)(29).[13] This modification will eliminate confusion and ensure unity of regulation, reporting, trading, and valuation for all direct and indirect holders of municipal securities. It will also help prevent market dislocations and a lack of clarity for investors.

I.E Transactions for Funding Purposes

The Proposed Rulemaking specifically excludes from the definition of a "trading account" those accounts that acquire positions arising under a repurchase or reverse repurchase agreement or a securities lending agreement. Such activities reflect the Agencies' view that these transactions are inherently for purposes of funding and asset-liability management, and are not executed based on any expected or anticipated movements in asset prices. In fact, Federal Reserve Governor Daniel Tarullo confirmed the intent of this exemption during the House Financial Services Committee's hearing on the Volcker Rule[14].

However, while we appreciate this exclusion, we are concerned that if the exemption is tied to the legal form of the underlying contract, it will be too limited in scope to achieve the Agencies' stated goal. We would suggest a modification that provides that transactions by a banking entity that are fundamentally for the purpose of funding or asset-liability management in which a banking entity takes title to financial instruments should be exempted, provided that the transactions can be demonstrated to result in economic and risk characteristics that are substantively the same as those of repo or reverse repo transactions.

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[13] Section 3(a)(29) of the Exchange Act provides that "[t]he term 'municipal securities' means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, <u>or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond . . . the interest on which is excludable from gross income . . .</u> " (Emphasis added.)

[14] Governor Tarullo, during the January 18th House Financial Services Committee Hearing titled "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation," stated: "The repo exception is meant to recognize the fact that it is essentially a borrowing relationship, and not a trading relationship…What you *do* with the financing, whether [from] deposits, long term bond issuance, or repo, is what the Volcker Rule addresses."

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I.F Quantitative Measurements

The proposed quantitative metrics will be a cornerstone of complying with the Proposed Rulemaking. As the Proposed Rulemaking would require new calculations that go beyond the data – and the granularity of the data – currently captured by many firms' financial and risk-management functions, banking entities must dedicate substantial resources and investment in infrastructure in order to produce some of the metrics. It is thus critical that the Agencies get these metrics "right," and that they are workable for banking entities to implement.

In addition, rather than organizing the requirements around fundamental processes and principles, the Proposed Rulemaking has attempted to touch on all the possible risk aspects within market making. This overly prescriptive approach has led to definitions that are, at times, ambiguous (which lends itself to the risk that different approaches by banks will result in inconsistent visibility and assessment), and more importantly, inconsistent with how finance and risk information are generally captured and managed.[15]

By way of example, we provide the following specific comments:

- <u>Spread Profit and Loss (P&L) & Pay-to-Receive Spread Ratio</u>: Although the intent of these metrics is clear, the requirements are overly prescriptive given the extensive data capture and development work that will be required to develop and calibrate these metrics. Calculating Spread P&L will require separation of customer level information in ways that are not typically captured by banking entities today as part of commission or sales credit tracking and the attribution of trading book P&L to customer transactions. We believe that creating a P&L attribution framework will require significantly different approaches for liquid and illiquid markets and for derivative and securities markets. Appropriate methods and the data available to implement these metrics will differ across banking entities. We urge the Agencies to expand the flexibility offered in choosing a bid-offer source to the entire process of calculating Spread P&L, and recommend that the Agencies adopt a similar expectation for alternative calculations for the Pay-to-Receive Spread Ratio.

- <u>VaR Exceedance</u>: This metric intends to capture the market impact on both the prior night's risk (a fundamental component of back-testing work used to validate the VaR model) and the trading activity from the following day (ex-Spread P&L). This incremental value requires banking entities to make judgments about how much P&L of this type is appropriate given the risk of the portfolio from the prior night. Although not completely independent, the level of activity on a given trading day has very little to do with how much risk a particular trading desk goes home with the prior night. Accordingly, aggregating the two P&L components and comparing the sum to VaR is misleading. Any conclusion made with regard to a threshold on this metric in assessing whether proprietary trading is occurring would be flawed. As such, we recommend this metric be withdrawn.

- <u>Customer-Facing Trade Ratio</u>: Comparing the *number* of trades executed with non-customers[16] versus customers, in an attempt to garner insight into the relative amount of activity between a banking entity and these market participants, is misleading. Frequently, in hedging a single customer transaction, traders will execute numerous trades to optimize the process of mitigating the risk at the best price. Such activity should not be viewed as more indicative of proprietary trading, but as sound business judgment. To

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[15] We note that the SEC has long recognized that compliance systems need to be reasonably designed to ensure compliance while having the flexibility to be tailored to regulated entities and their different businesses. *See, e.g.,* Sections 15(b)(4) and 15(f) of the Exchange Act; SEC Rules 15c3-5, 17a-3, and 17a-4.
[16] "Non Customers" as defined by Appendix A.IV.D.3 of the Proposed Rulemaking.

avoid such an erroneous conclusion, we recommend comparing a factor that measures the most material *risk*, as opposed to trade count.

- Inventory Risk Turnover & Inventory Aging: Calculating these metrics for multi-product trading units that transact in both over-the-counter derivatives and securities will produce misleading results. Although a workable solution would be to apply these metrics to the securities half of the trading activity alone, we at least ask that the Agencies rethink these metrics to account for the heterogeneous nature of trading units.

While the above suggestions reflect some of the concerns we have unearthed during our implementation efforts since the Proposed Rulemaking was announced on October 12, 2011, we expect that our list of concerns, together with those of other market participants, will only grow in length and complexity. Many of the proposed metrics require interpretation. For banking entities, this interpretation poses the risk that infrastructural investment will produce metrics that are not aligned with regulators' expectations; for the Agencies, the interpretation poses the risk that different approaches by banks will result in inconsistent transparency.

Given the complexity both in implementing and fine-tuning the calculation methodologies, we wish to be a constructive partner to the Agencies. We therefore recommend early and continual dialogue between regulators and covered entities on the metrics, and urge the full use of the conformance period for establishing and refining these metrics. We believe that time and flexibility will produce metrics that accurately guide regulators' assessment of trading activity while contributing to banking entities' effective risk-management.

Part II: Concerns Related to Investments in and Sponsorship of Covered Funds

II.A Permitted Market Making for Covered Funds Activities

The Volcker Rule, at Section 13(d), provides that certain "permitted activities" are exempt from the Section 13(a) prohibitions, which include both the prohibition on proprietary trading by banking entities and the prohibition on banking entities' investments in, and sponsorship of, hedge funds and private equity funds. The Proposed Rulemaking, however, curiously omits a number of these exemptions, including for market making, from its proposals relating to permitted hedge fund and private equity fund activities (see Proposed Rulemaking § __.11-14).

Banking entities structure notes and other products that provide customers with exposure to hedge funds and private equity funds. Banking entities typically hedge these products through direct investments in hedge funds or private equity funds. In general, we expect that the hedging activity in these covered funds will qualify for the Proposed Rulemaking's exemption for Permitted Risk-Mitigating Hedging Activity. However, clients expect that a banking entity will make a secondary market in the structured products it has issued to provide clients with liquidity between redemption dates for the underlying covered fund. We believe that offering clients secondary market liquidity, including taking principal exposure to the underlying asset between redemption dates, is consistent with the market-making activity Congress exempted from the Volcker Rule.

To prevent disrupting this customer-driven activity, and to remain consistent with the language and intent of the Volcker Rule, we therefore ask that the market-making and underwriting exemptions be expressly included in § __.13 of the Proposed Rulemaking.

II.B Concerns for Banks' Global Asset Management Businesses

i. Inclusion of 'Foreign Equivalent' Covered Funds

The Volcker Rule exempts from the covered fund prohibitions foreign funds where "no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States."[17] As currently drafted, however, the Proposed Rulemaking is inconsistent with the statute in that it includes foreign funds within its scope. We understand that the Volcker Rule gives the Agencies the authority to specify "similar funds" to hedge funds and private equity funds that should be included within its scope. However, we believe that the Agencies have gone too far in this regard.

a. *Foreign Funds with No U.S. Investors*

In the Proposed Rulemaking, the Agencies included as "similar funds" the foreign equivalent of any entity identified as a covered fund. In footnote 225, the Proposed Rulemaking clarifies this expansion of coverage by stating that a foreign fund is included if (i.e., assuming) it would need to rely on a Section 3(c)(1) or 3(c)(7) exemption from registration under the Investment Company Act of 1940, as amended ("'40 Act") were it sold to U.S. residents. This provision of the Proposed Rulemaking thus on its face includes funds that are not in fact offered or sold to U.S. residents and thus do not in fact need to rely on a '40 Act exemption. The Proposed Rulemaking is thus inconsistent with the Volcker Rule exemption for foreign funds.

b. *Foreign Regulated Funds*

The Volcker Rule was targeted towards hedge funds and private equity funds and not at publicly offered, regulated funds, whether in the U.S. or abroad. Accordingly, U.S. mutual funds, pension funds, and other registered investment companies are not covered by the Volcker Rule. We believe that non-U.S. mutual funds that are regulated in their home jurisdictions were similarly not intended to be captured by the Volcker Rule and should be excluded, even if they have limited distribution to U.S. residents in reliance upon Section 3(c)(1) or 3(c)(7) of the '40 Act ("non-U.S. regulated funds")[18]. The Proposed Rulemaking should thus be revised to explicitly exclude non-U.S. regulated funds from the meaning of covered funds.

While the Proposed Rulemaking contains an exemption from restrictions for covered funds activities outside the U.S. (the "foreign fund exemption"[19]), it is so complex as to appear all but unworkable. As noted, we believe that the Proposed Rulemaking would unnecessarily interfere with, and injure the activities of, non-U.S. regulated funds. But in our view the problems go beyond that. As drafted, the Proposed Rulemaking could negatively impact non-U.S. markets in which U.S. investors, including U.S. mutual funds, participate.

Non-U.S. regulated funds – like U.S. mutual funds (which, as noted above, are explicitly excluded from the Volcker Rule) – are not hedge funds or private equity funds. They are subject to home country regulation, including regulations limiting investments (such as the degree of leverage and the use of derivatives). Treating non-U.S. regulated funds as the equivalent of hedge funds and private equity funds would be unwarranted and inconsistent with Congressional intent.

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[17] Section 13(d)(1)(I).
[18] "Non-U.S. regulated funds" refers to collective investment vehicles organized outside the United States and subject to regulation under non-U.S. laws.
[19] The "foreign fund exemption" refers to § __.13(c) of the Proposed Rulemaking: "Certain permitted covered fund activities and investments outside of the United States."

c. *Impact of a Broad Expansion to 'Foreign Equivalents'*

The inclusion of foreign equivalent funds and non-U.S. regulated funds in the final rule would result in non-U.S. banking entities facing additional expenses and compliance burdens in numerous other countries as a result of how they or an affiliate accesses the U.S. banking market. The impact would be substantial given that many banks with headquarters in Europe, Latin America, and Asia would be subjected to the Proposed Rulemaking's requirements via a branch in the United States. Many global banks are actively involved in the management and distribution of investment funds around the world. The asset management division of UBS has offices in 26 countries – with thousands of employees around the world – including a substantial presence in Chicago and New York. The asset management division tailors a variety of investment products to meet local market interest and regulatory requirements, employing a variety of structures to meet local demand, including "UCITs[20]" – the most common form of fund offered to individual investors in Europe.

We are concerned that if the Proposed Rulemaking is not reformed, we, like many other asset management businesses around the world, may be subject to the Proposed Rulemaking in operating non-U.S. fund businesses, requiring massive changes to the management of such funds, extending to the very nature in which they are created and offered.

We respectfully request that the Proposed Rulemaking be revised to explicitly exclude from the definition of covered fund foreign equivalent funds and non-U.S. regulated funds to avoid the onerous and wholly unnecessary consequences that would burden firms around the world and negatively impact their shareholders.

ii. <u>Definition of "Banking Entity"</u>

While the Proposed Rulemaking incorporates an exclusion from the "banking entity[21]" definition for covered funds organized, offered, and held by a banking entity as a customer fund, we are concerned that other types of covered funds as well as customer funds that are not "covered funds" but that are affiliates of a banking entity would be considered banking entities. This would include non-U.S. mutual funds relying on the foreign fund exemption.

The Proposed Rulemaking recognizes the internal inconsistency of defining affiliated covered funds as banking entities. For similar reasons, we ask that non-U.S. regulated funds and similar entities be explicitly excluded from treatment as a banking entity to avoid themselves becoming subject to the Proposed Rulemaking. Failure to do this would result in irrational consequences, such as a non-U.S. regulated fund being subjected to a prohibition on proprietary trading. This would, of course, be inconsistent with the very nature of a pooled investment vehicle.

iii. <u>Definition of U.S. Resident</u>

The Volcker Rule permits covered fund activities occurring "solely outside the United States" by a banking entity not directly or indirectly controlled by a banking entity organized under

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[20] "UCITs" refer to Undertakings for the Collective Investment of Transferable Securities.

[21] The Proposed Rulemaking's definition of a "banking entity," contained in § ___.2(e), does not include "[A]n 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; or (ii) an entity that is controlled by a covered fund."

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U.S. law. However, the Proposed Rulemaking construes this exception so narrowly as to be virtually unworkable in practice. The foreign fund exemption relies on a novel definition of "resident of the United States"[22] that is much broader than the well-established concept found in the SEC's Regulation S. This will undoubtedly result in uncertainty, confusion, and inconsistency.

As proposed, the foreign fund exemption would ban incidental U.S. contacts in a manner that seems at odds with investor realities and long-established market practice, especially given the global range of asset management enterprises and the mobility of citizens in an increasingly interconnected world. It is so narrow as to give rise to concerns over whether it could be relied upon in practice and could result in foreign funds being subjected to the full restrictions and prohibitions of the Proposed Rulemaking applicable to hedge funds and private equity funds that operate under section 3(c)(1) or 3(c)(7) exemptions.

To prevent these likely consequences, we also request that the Proposed Rulemaking's definition of "resident of the United States" conform to concepts found in Regulation S. Without such conformance, non-U.S. funds and their sponsors may need to revamp their distribution and compliance processes at great cost and inconvenience, with no incremental protection that we recognize to the U.S. financial system.

iv. <u>Super 23A</u>

Under the Proposed Rulemaking, a banking entity serving as an investment advisor or sponsor to a covered fund is banned from entering into transactions with that fund where the transaction constitutes a "covered transaction" under Section 23A of the Federal Reserve Act ("Super 23A limitations"). As opposed to the "solely outside the U.S." exemptions crafted for covered funds and proprietary trading, the Proposed Rulemaking does not contain an exemption from Super 23A for covered funds that rely on the foreign fund exemption. Imposing the Super 23A limitations under such circumstances could constitute the application of U.S. bank regulatory prudential standards to entities not otherwise subject to U.S. law. Super 23A limitations do not have a place being applied to banking entities and covered funds that rely on the foreign fund exemption and could serve to disadvantage the citizens of other countries.

v. <u>Sharing a Name between a Banking Entity and a Covered Fund</u>

While U.S. SEC-registered mutual funds advised by an asset management unit of a U.S. bank are permitted to have names associated with the U.S. bank, non-U.S. regulated funds are not allowed to do so unless they fall within the foreign funds exemption. It is unreasonable to expect that global asset management firms will rebrand their product lines around the world to delete references to their identity because their non-U.S. funds could be considered covered funds under the Proposed Rulemaking and hence barred from having a name that references a banking entity subject to the Proposed Rulemaking. We understand that such a requirement would stand in direct conflict with the laws in many other countries. For example, it is our understanding that laws in the United Kingdom[23] and parts of Asia[24] all but

[22] "Resident of the United States" as defined in § ___.2(t) of the Proposed Rulemaking.
[23] FSA rule COLL 6.9.6G(2)(f) states that the FSA will take into account whether the name of a fund "might mislead investors into thinking that persons other than the authorized fund manager are responsible for the authorized fund."
[24] The Hong Kong Securities and Futures Commission's Overarching Principles for Collective Investment Schemes assesses the name of a fund on the merits of "[w]hether it might lead investors into thinking or create the impression that persons other than the product provider are responsible for the product."

require that the name of a fund sponsored or advised by a banking entity's affiliate reference the identity of that advisor.

II.C Employee Benefit Plans / Compensation Issues

i. Employee Benefit Plans

Section C.1.a of the preamble to the Proposed Rulemaking exempts U.S. tax-qualified plans from the covered fund prohibition by providing in relevant part as follows:

> *The Agencies note that the general prohibition in § ___.10(a) of the proposed rule applies solely to a banking entity's acquisition or retention of an ownership interest in or acting as sponsor to a covered fund 'as principal, directly or indirectly.' As such, the proposed rule would not prohibit the acquisition or retention of an ownership interest (including a general partner or membership interest) in a covered fund:*
>
> *(iii) by a 'qualified plan' as that term is defined in section 401 of the Internal Revenue Code of 1956 (26 U.S.C. 401), if the ownership interest would be attributed to a banking entity solely by operation of section 2(g)(2) of the BHC Act.*

In turn, section 2(g)(2)(C) of the BHC Act provides that shares held or controlled directly or indirectly by trustees for the benefit of the employees of a company are deemed to be controlled by such company, unless the FRB determines that such treatment is not appropriate in light of the facts and circumstances of the case and the purposes of the BHC Act.

As currently drafted, it is not clear whether the exclusion in (iii) above focuses on a plan's status as a U.S. tax-qualified plan, *i.e.,* only U.S. tax-qualified plans would be exempt from the Proposed Rulemaking, or whether the exclusion in (iii) focuses solely on the fact that the ownership interests are held or controlled directly or indirectly by a trustee for the benefit of employees.

Logically, and consistent with the Volcker Rule's focus on the banking entity acquiring or holding the covered fund interests 'as principal, directly or indirectly,' we believe that the final rule needs to explicitly provide that the Volcker Rule does not prohibit the acquisition or retention of an ownership interest in a covered fund by the employee benefit plans of a banking entity if such interest is held or controlled through a trust, insurance contract, or other trust-like vehicle (i.e., where the banking entity is not acquiring or retaining the interest directly or indirectly as principal), regardless of whether such plans are U.S. tax-qualified plans. Accordingly, employee benefits plans, including tax-qualified, nonqualified, and foreign-based plans, would not be prohibited from acquiring or retaining an ownership interest in a covered fund.

Our belief is supported by what should be the extraterritorial limits of the Volcker Rule. For example, if the exclusion in (iii) above focuses on a plan's status as a U.S. tax-qualified plan, banking entities would be in the position where their U.S. tax-qualified plans could acquire or retain interests in covered funds but their foreign plans could not acquire or retain interests in any covered fund that did not meet the foreign fund exemption. As an even more extreme example, because of the possible coverage under the Proposed Rulemaking of "foreign equivalent funds" as described in the section above, banking entities may be in a position where their foreign retirement plans violate the Volcker Rule if they invest in such foreign equivalent funds (for example, a retirement plan in Russia investing in Russian mutual funds). Such results are illogical and beyond what should reasonably be the extraterritorial reach of the Volcker Rule. We do not believe that Congress intended to prohibit banking entities from sponsoring and maintaining retirement and other compensation plans that invest in covered funds or non-U.S. funds that could fall within the Proposed Rulemaking's definition of "covered fund."

ii. <u>Extraterritorial Reach with Respect to Employee Benefit Plans / Compensation</u>

In addition to the above issue relating to employee benefit plans, we do not believe that the Agencies have fully considered the impact of the Proposed Rulemaking on the compensation arrangements and mobile workforces of foreign banking entities. Specifically, the foreign fund exemption provides that the covered fund prohibition does not apply to the acquisition or retention of any ownership interest, or the sponsorship of, a covered fund by a covered banking entity if, among other requirements, the activity occurs "solely outside of the United States." In turn, an activity is considered to have occurred "solely outside of the United States" only if, among other requirements, "no ownership interest in such covered fund is offered for sale or sold to a resident of the United States."

We believe that this exception is too narrowly written and unfairly hampers the ability of banking entities to maintain and sponsor their compensation arrangements and maintain a mobile workforce. For example, if the exception described in Subpart A above for U.S. tax-qualified plans is not expanded, a banking entity's foreign retirement plans would not be permitted to invest in the same covered fund that the banking entity invests in for its U.S. tax-qualified plans and U.S. workforce because an ownership interest in such covered fund is offered for sale or sold to a resident of the United States. We do not believe that Congress intended that what would be permissible activity for U.S. employee benefit plans would not be permissible for non-U.S. employee benefit plans.

In addition, it is very common for banking entities to transfer their employees from the United States to foreign countries and from foreign countries to the United States in order for these employees to develop a better understanding of the banking entity as a whole. As the foreign fund exemption is drafted, it appears that a banking entity would run afoul of the exemption if foreign employees transfer to the United States and those employees continue to participate in a foreign compensation plan that invests in a covered fund because an ownership interest in the covered fund would be offered or sold to a resident of the United States. We believe that such an extraterritorial approach is not consistent with Congress's intent in drafting the Volcker Rule and that such an application of the Proposed Rulemaking would hamper and impede banking entities in their employment and employee benefit decisions. In addition to our request above to explicitly exclude employee benefit plans from the covered fund prohibition, adopting a definition of "resident of the United States" that mirrors the definition in the SEC's Regulation S (including the explicit exclusions in Regulation S such as the employee benefit plan exclusion), as requested earlier in this letter, would eliminate some, if not all, of the concerns for banking entities that employ international assignees.

Conclusion

We have numerous other concerns about the Proposed Rulemaking as currently drafted, but we believe they have been addressed at length in other comment letters. In particular, we generally support the comments of SIFMA and the Institute of International Bankers in this regard.

We appreciate the difficulty of the task facing the Agencies and hope that we can be helpful

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to the Agencies' efforts to implement the Volcker Rule in a workable and effective manner. We appreciate your consideration of our comments and concerns. Please do not hesitate to contact the undersigned if you have any questions regarding our comments or if we can be of any further assistance.

Very Truly Yours,

Mark S. Shelton	Darryll Hendricks
General Counsel, Americas	Head of Strategy, Investment Bank