The International Regulatory Strategy Group is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to contribute to the shaping of the international regulatory regime, at global, regional and national levels, so that it promotes open, competitive and fair capital markets globally, supporting sustainable economic growth. It role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views. It is an advisory body both to the City of London Corporation, and to TheCityUK which is an independent practitioner-led body set up to co-ordinate the promotion of the UK-based financial and professional services industry.
The International Regulatory Strategy Group (IRSG) welcomes the opportunity to comment on the proposed rules which will enact Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank'), commonly called the 'Volcker Rule'.

The response sets out, at a high level, the IRSG's view on the Volcker Rule for financial institutions, as well as its view on the implications of the rule being enacted as currently proposed for the wider economic and business environment. The IRSG is aware that a number of bodies, including non-US regulators, have already commented to the US agencies on the Volcker Rule implementation proposals, underlining the international concerns with the proposals which the IRSG echoes.

### The Scope of Application of the Volcker Rule implementation proposals

The extraterritorial scope of the proposal is problematic in a number of ways. We understand that other comment letters are discussing these issues and we have therefore concentrated in this letter on specific aspects of this issue.

The Dodd-Frank Act specifically limited the extra-territorial effect of the Volcker Rule by enacting the Non-US Trading and Funds Provisions ('the Provisions'); these permit international banks to engage in proprietary trading and to invest in funds ‘solely outside the US’.

The current drafting presented by the US Agencies interprets ‘solely outside the US’ in such a way as to bring in to scope any transaction to which any US resident (which is so broadly defined as to include non-US branches and agencies of US banks) is a party. The proposed rule’s proposed definition of resident of the United States should be amended so that it does not include any agency or branch of a US person located outside the United States if the agency or branch operates for valid business reasons, is engaged in the business of banking and is subject to substantive banking regulation in the jurisdiction where located.

### Economic impact

The IRSG is concerned that the proposals will lead a number of businesses to cease or dramatically reduce activities in the US – or, where they judge the US activities to be vital, to have to consider withdrawal from activities they quite legitimately conduct in other jurisdictions. While it is difficult to assess the potential damage of such moves, the damage is expected to be significant.

### Definition of 'proprietary trading'

The approach to defining the restrictions appears overly restrictive on the normal economically necessary activities of banks. For example, it captures activities such as stabilisation, broadly recognised as a legitimate part of bond issuance, and market making.

To act as a market maker in financial instruments of any kind, a bank must be able to put its own capital at risk because it may not immediately be able to re-sell those instruments. If, say, a security held in a bank's trading account goes up in value, this may be construed as bringing the bank within the definition of proprietary trading. For banks which engage in reasonable market making activity, this raises a challenge – how does a bank maintain sufficient stock to satisfy client demand, while at the same time ensuring it either does not contravene the proprietary trading ban or that it fits into the strict conditions of one of the exemptions from the ban?

Market making facilitates critical economic activity, by providing and maintaining liquidity, specifically in terms of:

- capital raising by corporations, which in turn funds investment (e.g., R&D, expansion, etc.); and
- savings activity of institutional investors such as pension funds, etc., which are carried on on behalf of individual savers.

Japanese and Canadian regulators have already voiced concerns that the proposals would have an adverse impact on sovereign bond trading, raising the costs of transactions in sovereigns, which (it is reasonable to expect) would in turn adversely affect liquidity and pricing of sovereigns. In light of the difficult economic conditions in the majority of major global economies, to proceed with the proposals in their present form seems likely to damage the US domestic economy, relations with other major G20 economies and market making in the
international financial markets. The range of exempted securities should be expanded beyond US government securities. At the very least, it should be expanded in the case of non-US banks. The IRSG would however encourage the Agencies to allow US banks too to trade in foreign government securities – failure to do so is likely to result in serious damage to fragile global economy.

**Ban on proprietary trading for covered bank entities**

This would have an adverse impact on the liquidity obligations of other global banks. The Rule provides an exemption for US government securities, but not for non-US government securities. This would have an impact on the ability of international banks to hold debt backed by non-US governments, and may not be consistent with various US treaty obligations, including NAFTA in the case of Canada and Mexico. As such, the proposal is bad both for banks and their sovereigns.

**Ban on sponsored funds – private equity and hedge funds**

This provision is drafted broadly and will pick up standard structured product funds. In addition, the definition of “US residents” is not properly defined and, therefore, problematic.

**Hedge fund investment**

The prohibition on fund investment in the proposals for implementation of the Volcker Rule is broader than the range of activities traditionally considered as own-account investment in hedge funds or private equity investment. It extends (for example) to special purpose vehicles commonly used in securitisation and some (though not all) joint ventures.

While the rules also provide for a foreign banking entity exemption, the exemption's terms are onerous. Specifically, the exemption requires a banking entity to demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the US, and:

- The transaction or activity is conducted by a banking entity that is not organised under the laws of the US or of one or more states.
- No subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the private equity fund is incorporated or physically located in the US.
- No ownership interest in such fund is offered for sale or sold to a resident of the US.

The Volcker Rule also prohibits certain transactions (including transactions taking place wholly outside the US with no US nexus) between a banking entity and any fund within the Volcker Rule definition for which the bank or any of its affiliates is the investment advisor, investment manager or sponsor. These transactions include, for example, extension of loans or letters of credit (the so-called ‘Super 23A’).

**Monitoring compliance**

The 12th January Memorandum prepared by the House Committee on Financial Services comments that ‘the regulators have estimated compliance with the proposed rule would require financial institutions to expend 6.2 million man-hours’; although the IRSG assumes that this includes initial implementation and ongoing monitoring, it nonetheless indicates quite a resource-intensive exercise. Even if banks attempt to remove themselves from the scope of application of the Volcker Rule by ceasing activity in the US or by ceasing activity with US clients and entities (including overseas subsidiaries of US banks), an extensive compliance programme will still be required in order to evidence that the bank has not, in fact, contravened US regulation. The IRSG would query whether the imposition of this cost delivers tangible benefits for US financial stability or for the financial stability of individual institutions.
Application to fund industry

Impact on managers: “bank holding company” is defined such that an asset manager that controls, is controlled by or is commonly controlled with a US bank will be caught. Asset managers which are part of non-US bank groups may be caught if there is a US bank or a non-US bank with a US branch or agency within the group.

Impact on non-US funds: the definition of “covered fund” as set out in the proposed regulation catches all non-US funds, including non-US regulated retail funds which would be the equivalent of a US mutual fund if they were in the US. So the Volcker Rule as currently drafted treats all non-US funds as if they were US private equity or hedge funds. The IRSG thinks that the proposed definition is too wide. Non-US regulated funds should be treated in the same way as their US counterparts.

“Solely outside the US” exemption is too narrow: as proposed, the “solely outside of the United States” exception for covered fund activities is so narrowly drawn that it is unlikely to be available to many non-U.S. banking entities’ covered fund activities even though they take place “outside the United States” as that concept has been widely understood for years for purposes of the U.S. securities laws.

Impact on managers with no US connection: any “banking entity”, including a bank holding company, will not be able to invest in a “covered fund”. This reduces the universe of potential investors.

Possible impact on trust structures, custodians and administrators: European and other non-U.S. regulatory regimes impose significant responsibilities on to non-U.S. regulated funds, which are greater than those imposed on such service providers for U.S. registered investment companies. As proposed, the Volcker Rule could potentially cause banking entities that serve as custodians, trustees and administrators to be deemed “sponsors” of non-U.S. regulated funds, potentially causing the relationship between the banking entities and the respective funds to be subject to the restrictions of the Volcker Rule and causing funds that otherwise would not be covered funds to become covered funds.

Possible impact on liquidity: the proposed rules do not include a specific exception from the covered fund activities prohibitions for underwriting, market making and insurance company general account investments as is included for proprietary trading activities. This may have an impact on the fund’s liquidity.

Application to insurance companies

The Volcker Rule implementation proposals are drafted in contemplation of US companies' structures, which are necessarily different from the structures used in non-US jurisdictions. While insurance activities per se are exempt from Volcker Rule implementation, the IRSG believes there are significant consequences for insurance companies which have asset management entities within the group, even if those asset management entities and their clients are based outside the US. These consequences mirror those outlined above.

The provision of an exemption for non-US entities on the condition that an assurance is given that no clients offered or sold to are US residents is unrealistic.

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