The Clearing House

February 13, 2012

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551
Docket No. R-1432
RIN 7100 AD 82

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220
RIN 3235-AL07
File No. S7-41-11

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Attention: Comments
RIN 3064-AD85

David A. Stawick, Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
RIN: 3038-AD05

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219
Docket No. OCC-2011-0014
RIN 1557-AD44

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

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**")[1] is writing to comment on the joint notice of proposed rulemaking (the "**NPR**" and, the proposed regulations

1 Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks,

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set forth therein, the "**Proposed Regulations**") issued by the Board of Governors of the Federal Reserve System (the "**Board**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), the Office of the Comptroller of the Currency (the "**OCC**") and the Securities and Exchange Commission (the "**SEC**") to implement Section 619 (the "**Volcker Rule**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the notice of proposed rulemaking issued by Commodities Future Trading Commission (the "**CFTC**," and, together with the Board, FDIC, OCC, and SEC, the "**Agencies**").[2] The Volcker Rule generally places prohibitions or restrictions on the ability of banking organizations and Board-supervised nonbank financial companies to engage in proprietary trading and have interests in, and certain relationships with, hedge funds and private equity funds.

The Association supports the overall concept and many specific aspects of the ongoing national and international regulatory reforms to make the financial system safer and more robust, and we recognize that the Volcker Rule is designed to advance this objective. We have, however, deep concerns that the Agencies' basic approach in the Proposed Regulations in implementing the Volcker Rule will, instead, have potentially far-reaching negative effects on

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which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the United States. *See The Clearing House web page at www.theclearinghouse.org*.

[2] The CFTC's rulemaking is substantially similar to the Proposed Rule. Accordingly, references to the Proposed Rule in this letter also refer to the CFTC's rule.

U.S. and global financial markets, the safety and soundness and competitive position of banking entities subject to the Rule, and the recovery of the U.S. economy.[3] Specifically, the Proposed Regulations incorporate an approach under which (i) the Volcker Rule is initially implemented in a highly restrictive manner that is designed to resolve definitively all its complex requirements; and (ii) if, during the conformance period, it is determined that the Proposed Regulations are unnecessarily stringent, they will subsequently be revised to reduce unnecessary harm to the markets and the individual banking entities.

We submit that this approach is ill-conceived as it would create a serious threat to the markets, the customers of banking entities and banking entities themselves. The assumption that only limited damage would occur and that the financial system will be self-correcting at some future point is both unproven and risky given current market fragility and the urgent need for economic recovery.

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3 Similar concerns have been voiced by members of Congress. *See*, *e.g.*, Letter from Certain Representatives to the Agencies (Dec. 20, 2011) ("The complexity of these issues necessitates a deliberative and thoughtful process that considers an appropriately tailored proposal to improve safety and soundness without disrupting market liquidity for investors and the flow of capital to American businesses."); Letter from Sen. Kirsten Gillibrand to the Agencies (Jan. 25, 2012) ("The ability of firms to continue to make markets, particularly in less liquid markets is important for the continued competitiveness of the U.S. financial industry and the broader strength of the U.S. economic system which relies on deeply liquid financial markets. As you proceed with the final rule, I encourage you to continue to strive to strike this important balance to ensure that our financial institutions remain both safe and competitive."); Letter from Sen. Kay Hagan to the Agencies (Jan. 13, 2012) ("Restrictions that impede the ability of firms to make markets could reduce liquidity and trigger unintended consequences . . . . I urge regulators to carefully evaluate the impact of the proposed rule on the ability of firms to make markets and to avoid regulations that could reduce market liquidity, discourage investment, limit credit availability, and increase the cost of capital for companies.").

At the outset, there will be a natural reluctance for the Agencies to revisit, on a coordinated basis, rules promulgated after a prolonged and exhausting process, particularly when they have other pressing matters.

Of even more importance, banking entities cannot plan and operate their businesses based on the assumption that at some undefined point in the future there may be relief from prohibitions and restrictions that were initially adopted but ultimately prove unnecessary. Banking entities will need to take action promptly after the rules are promulgated in order to avoid violations of law, and will restructure their operations on the basis of the final rules as issued—not on the possibility that a modified regime may emerge after the conformance period. If, for example, banking entities are forced to eliminate certain parts of their market-making business, it will be difficult to reestablish those parts at some future date. Indeed, the loss of the ability to engage in certain parts of the market-making business may force banking entities to consider shuttering the entire business.

Of perhaps greatest significance, the global markets will adapt quickly to any major regulatory change, and precedent suggests that, once they adapt, the competitive position of the U.S. financial system will suffer irreparable damage. The history of the Eurodollar market provides a real-life example of this risk. In the early 1960s, the U.S. Government became increasingly concerned about the level of U.S. capital outflows, and, in response, an interest equalization tax was imposed on foreign issuances. This tax, combined with other restrictive regulations,[4] resulted in the development of a huge Eurodollar market at

[4] Cooper, Richard & Little, Jane, *Competition & Opportunity: How International Forces Spurred Innovation in U.S. Banking*, Regional Review 19 (2001) (noting that Voluntary

the expense of U.S. financial markets and their competitive primacy.[5] Some years later, U.S. policy was reversed, but the damage to the U.S. markets proved to be irreversible. Today, the Eurodollar market is estimated at over $5 trillion and is a major source of capital for multinational companies.[6]

In evaluating the risk of a similar development, to the detriment of U.S. markets, in the case of the Proposed Regulations, it is essential to recognize that -- unlike the capital, liquidity and other rules that are being promoted on an international or at least coordinated basis -- there appears to be no real counterpart to the Proposed Regulations in any other country. This will undoubtedly result in migration of transactions, markets and jobs outside the United States.

Foreign Credit Restraint Program contributed to the movement of investors to the Eurodollar market); Levi, Maurice, International Finance 504 (5th ed., 2009) (noting that other requirements, such as Regulation Q and Regulation M, also contributed to the growth of the Eurobond market).

5 *See, e.g.*, Klopstock, Fred, *Impact of the Euro-Markets on the United States Balance of Payments*, 34 Law & Contemp. Probs. 157, 158 (1969) ("[The interest equalization tax] made long-term borrowing in the United States prohibitively costly . . . and led to the virtual closure of the New York capital market for foreign bond issues of almost all industrial countries."); Neely, Christopher, *An Introduction to Capital Controls*, 81 Fed. Res. Bank. St. Louis Rev., n.6, 13, 24 (1999) ("For example, the volume of international borrowing in London rose from $350 million in 1962 to more than $1 billion in 1963 while the volume of foreign flotations in New York fell from $2 billion in the first half of 1963 to just over $600 million in the next nine months."); *see also* Laulajainen, Risto, Financial Geography: A Banker's View 343 (2003); Ahmed Zoromé, *Concept of Offshore Financial Centers: In Search of an Operational Definition* 24-25 (IMF, Working Paper No. 07/87, 2007), *available at* http://www.imf.org/external/pubs/ft/wp/2007/wp0787.pdf.

6 Carbough, Robert, International Economics 531 (2010) (eurodollar market is over $5 trillion); Kim, Kenneth, Global Corporate Finance: A Focused Approach 198 (eurodollar market is major source of capital for multinational companies).

Another key example of potentially irreversible damage relates to the likely draining of liquidity and funding from the markets due to a number of factors: a rigid concept of permissible market-making; the absence of an exemption for sovereign debt other than U.S. Treasuries; and the application of the covered fund prohibitions to entities that provide capital and funding but are clearly distinct from traditional private equity and hedge funds. Once the markets are drained of liquidity and funding is curtailed, the markets will be forced to adjust immediately. At a minimum, the cost of capital and credit will rise and, in some cases, capital and credit will simply be unavailable.

In this context, it is important to recognize, as Chairman Volcker forthrightly has, that the activities prohibited by the Volcker Rule were not responsible for the failure of any regulated banking organization.[7] We agree with Chairman Volcker that regulation should be forward-looking; however, a highly restrictive initial approach, with the prospect of later liberalization, is far less defensible when directed against possible rather than proven problems, particularly when potential adverse consequences may be irreversible.

Moreover, the Volcker Rule itself, together with the existing supervisory and enforcement authority of the Agencies, provides a number of safeguards against the possibility that a more balanced approach would result in the emergence of significant loopholes and serious risk for the system. In the first place, the Agencies have both an extensive supervisory

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7 Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs, 111th Cong. 27-28 (2010) (statement of Paul A. Volcker, Chairman, President's Economic Recovery Advisory Bd.) ("[The Volcker Rule] certainly would not have solved the problem at AIG or solved the problem with Lehman, alone. It was not designed to solve those particular problems.").

process for reviewing compliance and explicit authority under the Volcker Rule to prevent evasions if banking entities attempt to disguise impermissible activity. These avenues for monitoring compliance with the Volcker Rule are reinforced by the Agencies' enforcement authority, which, in the current environment of rigorous enforcement actions and very substantial monetary penalties, has a significant deterrent effect. Beyond the Volcker Rule itself, new capital requirements relating to the trading book and market risk and other regulatory requirements provide substantial protection against undue risk.

For these reasons, we urge the Agencies to reject an implementation approach for the Volcker Rule that is based on the assumption that harm to the markets, customers and financial institutions resulting from unnecessarily restrictive regulations can be corrected after the Agencies evaluate the conformance period experience. We accept that, over time, and with experience, the Agencies will likely need to revise their implementing regulations as they develop an improved appreciation of how to identify and monitor for impermissible proprietary trading and which types of investment vehicles are appropriately characterized as hedge funds and private equity funds. It is critical, however, that the final rules not be based on the unrealistic expectation that harmful and unintended consequences could be reversed following the conformance period. The final rules must provide a truly meaningful ability to adjust as experience and circumstances warrant. Any other approach would create the very harm to the financial system that the Dodd-Frank Act and the Volcker Rule were designed to prevent.

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If you have any questions, or need further information, please contact Dan McCardell, Senior Vice President and Head of Regulatory Affairs, of The Clearing House at (212) 613-0164 (email: Dan.McCardell@theclearinghouse.org).

Respectfully submitted,

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The Clearing House Association L.L.C.

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Hon. Mary Miller
Department of the Treasury

Hon. Cyrus Amir-Mokri
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Hon. Ben Bernanke
Board of Governors of the Federal Reserve System

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