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By Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20551

Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20520

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Comments on the Notice of Proposed Rulemaking Implementing the Volcker Rule Proposal (Federal Reserve Docket No. R-1432 and RIN 7100 AD 82; FDIC RIN 3064-AD85; OCC Docket ID OCC-2011-14; SEC File Number S7-41-11; CFTC RIN 3038–AC) – Proprietary Trading Issues

Credit Suisse[1] appreciates the opportunity to provide comments on Proprietary Trading issues to the Federal Reserve, the FDIC, the OCC and the SEC (together, the "**Agencies**") regarding the Agencies' notice of proposed rulemaking[2] to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Volcker Rule**").

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[1] Credit Suisse AG is one of the world's leading financial services providers and is part of the Credit Suisse group of companies (referred to here as 'Credit Suisse'). As an integrated bank, Credit Suisse offers clients its combined expertise in the areas of private banking, investment banking and asset management. Credit Suisse provides advisory services, comprehensive solutions and innovative products to companies, institutional clients and high-net-worth private clients globally, as well as to retail clients in Switzerland. Credit Suisse is headquartered in Zurich and operates in over 50 countries worldwide. The group employs approximately 49,200 people. The registered shares (CSGN) of Credit Suisse's parent company, Credit Suisse Group AG, are listed in Switzerland and, in the form of American Depositary Shares (CS), in New York.

Credit Suisse understands the difficulty of the task that the Agencies have been given by Congress in implementing the Volcker Rule - defining and distinguishing inappropriate proprietary trading from legitimate and necessary market activities. The consequence of miscalculating this balance is unnecessarily chilling legitimate market activity which, in turn, will result in loss of liquidity in secondary trading markets. Considering the asset classes most at risk, such as corporate bonds and mortgage backed securities, a material drain of market liquidity would have potentially negative corollary effects to the real economy. Agency staff have acknowledged in meetings with Credit Suisse management representatives that they share these very concerns and that their intent is *not* to fundamentally restructure or materially disrupt the continuing operation of trading markets as they exist today. In deference to this concern, the Proposal includes several provisions intended to accommodate legitimate trading activities (e.g., market making in illiquid markets).

We believe, however, that the proposed regulations, as currently drafted, do not adequately balance these objectives. The Proposal is far too focused on seeking to identify each and every instance of potential proprietary trading and establishes a set of presumptions that (i) do not accord with the realities of the financial markets as they currently operate, and (ii) impose a very onerous burden on a banking entity attempting to rely on permitted activity exemptions such as market-making or risk mitigating hedging.

We believe that this approach – a very detailed set of requirements (many of which will not distinguish prohibited proprietary trading from legitimate market activity) and a "guilty until proven innocent" evidentiary burden will have a severe chilling effect that risks inflicting material harm upon the very same financial markets that the regulations are meant to bolster and protect. We also disagree with the notion that currently unregulated institutions will move to fill the voids created by the market disruptions that this rule may create because such market participants do not appear to have the capacity, infrastructure, controls, risk management functions, or capital to support or replace the wide range of trading activities currently conducted by covered banking entities.

In order to eliminate or mitigate the feared chilling effect and better implement the Congressional intent of the rule, the Agencies should revise the Proposal by (i) removing some of the purported defining characteristics of prohibited proprietary trading that may likewise manifest themselves in connection with legitimate trading activity, and (ii) reverse the negative presumption implicit in the regulations so as to encourage banking entities to continue to take an active role in the U.S. financial markets.

We provide in this letter a description of the potential negative impacts of the current Proposal and outline some preliminary suggestions to mitigate them. The suggestions in

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[2] Prohibitions and 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) (the "**Proposal**"); Given the distinct nature of the issues, Credit Suisse is also filing a separate comment letter on the covered funds trading provisions of the proposed Volcker Rule.

this letter, however, should not be seen as the full extent of the ways in which Credit Suisse believes the Proposal can be improved. Credit Suisse supports the recommendations set forth in the comment letters submitted by the Securities Industry and Financial Markets Association and the Institute of International Bankers.

The Proposal could decrease liquidity in the financial markets.

The U.S. financial markets are the most liquid in the world. They allow U.S. corporations to increase production and hire U.S. employees, and allow U.S. asset managers to safely invest the earnings of U.S. workers. The Proposal threatens the liquidity of the U.S. financial markets and these key benefits through an overly narrow view of market making-related activities.

The combination of the focus on the positional intermediary function and the negative presumption that any transaction that does not meet the stringent requirements of the permitted activity is prohibited, will drastically chill market making as we currently know it in all but the most liquid instruments. This bias is contrary to congressional intent. Congress explicitly intended covered banking entities to engage effectively in market making-related activity in all types of financial products. Had Congress intended to limit market making to agency-like transactions in liquid equity markets, the statutory Volcker Rule would have been constructed to do so. The Agencies can, and should, allow for market making in all markets.

Financial markets exist to allocate capital efficiently by allowing corporations, governments, financial institutions and individuals to finance activities for which they do not have sufficient funds on hand, to invest money they do not currently need and to mitigate risks. These markets work by matching sellers of financial instruments (for example, a corporation that wishes to finance a new project) with buyers of financial instruments (for example, an asset manager who has money to invest). It would be prohibitively time-consuming and expensive for these sellers and buyers to find each other directly. Instead, intermediaries in financial markets known as "market makers" stand ready to buy from the sellers and sell to the buyers.

In some markets, individual financial instruments are actively bought and sold. In these "liquid" markets, market makers serve as positional intermediaries, standing between buyers and sellers that do not know each other, and bridge brief time gaps between the availability of buyers and sellers. These market makers are primarily short-term conduits in trades between market participants. They are primarily compensated by a "spread" between the price at which they buy from the seller and sell to the buyer.

These active, liquid markets, however, are far from the norm. In most markets, individual financial instruments are traded infrequently with extended gaps between when a seller wants to sell an instrument and when a buyer wants to purchase it. As a result, market makers in these instruments serve not only as positional intermediaries between a buyer and seller who might not otherwise be able to find each other, but also as temporal intermediaries between a buyer and a seller whose needs arise at different times.[3] These market makers act in a principal capacity, taking on risk from sellers until a buyer arrives, building inventory and hedging positions.

While the Proposal, as currently drafted, attempts to allow for market-making in illiquid markets, it focuses primarily on the positional intermediary function of market makers – the way the Agencies believe that market making occurs in the liquid equities markets.[4] In doing so, it ignores the second, and particularly critical, function of a market maker as an intermediary through significant gaps in time. It also ignores the resulting challenges that holding positions for significant time periods as principal may have for the banking entity. For example, the Proposal requires that market making activities be predominantly designed to generate revenues from commissions, fees and bid-ask spreads rather than from changes in the price of financial instruments. When positions are held over time, however, the prices of instruments are likely to change and contribute to the market maker's profit and loss in a way that depends on the dynamics of the instrument and the market.

Likewise, the Proposal embeds in its articulation of market making principles other presumptions that are not consistent with how market makers currently operate in principal trading markets today. For example, the Proposal sets out an expectation that permitted market making does not require taking much market risk, incurring revenue volatility, or compensating traders based on their success in profitably managing risk for the firm. These presumptions reflect an unrealistic perception that dealers act solely as "brokers" and intermediate traders on effectively a riskless principal basis. Enforcement of these expectations would impose a sea change in the way dealers function in our markets.

Applying the standards of the liquid equity markets to market makers in other instruments will force banking entities out of a wide variety of less-liquid markets, further decreasing liquidity in those markets and threatening their existence. For example:

- **Corporate bonds.** Market makers in the corporate bond market, which is significantly more fragmented and less liquid than the exchange-traded equity market, buy bonds from customers who seek liquidity with the knowledge that they may have to hold on to the bond for some time. As such, they take principal risk. During the time they hold the position as principal, changes in interest rates, market conditions and creditworthiness of the issuer may significantly change the price of the bond. As a result, market makers in corporate bonds must assess whether a position in the bond will appreciate or depreciate over the time they expect to hold it and strive for profit rather than loss from these price moves. If

[3] Market makers also serve as intermediaries in size when, for example, a seller wants to sell a block of stock larger than the market can bear at any given point in time.

[4] We note, however, that the market making-related permitted activity is not even broad enough for these liquid equities markets. For example, market makers in liquid equities markets often need to build inventory which, as discussed below, is not appropriately accounted for in the permitted activity.

fixed income market makers are not allowed to do so, they will exit the corporate bond market.

- **Equity derivatives.** Market makers in equity derivatives provide liquidity to customers in what are often individualized, bespoke contracts by entering into a contract with a client and managing the risk of that trade through hedging. There may be delays in hedging the position that lead to holding principal risk for some period of time. There also may not be sufficient liquidity in the market, requiring the equity derivatives desk to take the other side of a customer position and trade out of the position over time. In addition, hedges are likely to be imperfect. As a result, market makers in equity derivatives assess whether the position will appreciate or depreciate over the time they expect to hold it. If these market makers are exposed to losses without the potential for profit, they will exit the equity derivatives market.
- **Securitized products.** Market makers in securitized products stand ready to accommodate customers in very illiquid products such as mortgage-backed securities. The "customers" in this context may be other dealers. Any particular securitized product trades very infrequently and may be very difficult to hedge. The securitized products desk often restructures and subsequently markets positions, but this process may take significant time. As a result, a significant portion of the profit or loss of the market maker's book can result from whether the product appreciates or depreciates during the time it is held. The significant market value of market makers' inventory makes it difficult to imagine that financial entities other than banking affiliates could intermediate in this market.
- **Emerging markets.** Market makers in emerging markets provide liquidity to customers in very illiquid financial instruments. These positions are often difficult to hedge. Therefore, these market makers assess whether a position is likely to appreciate or depreciate. If not allowed to do so, they would cease functioning as market makers.
- **Foreign exchange forwards.** Market makers in foreign exchange forwards frequently warehouse risk before it can be effectively hedged. This is particularly true late in the U.S. trading day when there might not be liquidity in Asian currencies or the Euro until the next day. If market makers are effectively prohibited from profiting from positions that move in their favor during that time period, but still may lose money for positions that move against them, the market makers cannot operate in the foreign exchange market during these sensitive late-day periods. In addition, inventory of foreign exchange derivatives is critical to serve foreign exchange clients.
- **Fund-linked products.** Market makers in fund-linked products provide customers with access to a broad array of investment opportunities in covered funds and in structured products that provide a rate of return linked to the return of the underlying funds or fund indices. While we address other issues with fund-linked products in our letter on the covered funds restrictions in the Proposal, we note here that the Proposal presents the same problems with respect to market making in covered funds and fund-linked products as it does for other less liquid assets. Hedge funds and other covered funds are illiquid with infrequent redemption windows, notice periods, lock-ups or other liquidity restrictions. In

addition, many of the fund-linked structured products have non-standard payouts, including leverage, principal protection and optionality. As there are a multitude of funds or indices that can be linked to, and a multitude of ways in which any note can be structured, the market for any particular fund-linked product may be very illiquid. It may also be very difficult, if not impossible, for the banking entity to perfectly hedge the product.

While these markets differ, common themes emerge. First, in less liquid markets, market makers need to act as principals to facilitate client requests and, as a result, will be exposed to risk. Second, positions may need to be held for significant amounts of time and hedges are likely to be imperfect, exposing a trading desk's positions to potential profits and losses. Third, banking entities will cease being market makers if they are unable to take into account the likely direction of a financial instrument, or are forced to take losses if the instrument moves against them but are prohibited from taking gains if the instrument moves in their favor.

Fourth, the bid-ask spread to be earned in these markets can be dwarfed by the positive or negative impact of price moves, meaning that revenues often result from market movements in the financial investments. Fifth, the interdealer market is critical to ensure liquidity. Sixth, inventory is critical. Finally, it is not clear which financial entities, if any, could take over the banking entities' role, as significant capital is needed to hold inventory in less liquid products over time.

The negative effect of limiting banking entities' ability to function as market makers is already becoming apparent. Anticipatory responses by financial institutions have noticeably reduced liquidity across a number of markets by encouraging market participants to close or restructure parts of their trading operations. This is hurting liquidity and increasing volatility, which portends increased systemic risk in the case of a financial downturn. For example, cross-asset realized correlations across the most heavily traded equities have been around 80% since August 2011, which we believe is partially attributable to the sovereign debt crisis in Europe, but also partially attributable to anticipatory Volcker responses by financial institutions.

Finally, the Proposal's limits on hedging will significantly limit the liquidity of markets due to the close link between hedging and market making. Without an adequate way to hedge market making positions, some of which (as discussed above) may be held for a period of time, banking entities will have difficulty making markets in less liquid products and may have to charge bid-ask spreads in excess of a size that would permit a well-functioning market. While the Agencies have recognized the need for market making-related hedging, they have set the standard too high. In addition, the market making-related hedging provision incorporates all of the problematic hedging requirements discussed further below.

To remedy these problems to avoid decreasing liquidity, the Agencies should:

- more fully recognize and accommodate the characteristics of market-making in illiquid markets and eliminate the presumptions regarding volatility and level of risk;
- limit the prohibition on generating significant revenues from, and compensating market making traders based on, changes in the price of a financial instrument;
- explicitly define "customer" to include any counterparty to whom a banking entity is providing liquidity;
- allow market makers to build inventory in products where they believe customer demand will exist, regardless of whether the inventory can be tied to a particular customer in the near-term or to historical trends of customer demand; and
- encourage market making-related hedging.

The Proposal could increase transaction costs for asset managers and corporations.

U.S. financial markets enable asset managers and corporations to pay among the lowest transaction costs in the world, allowing them to make beneficial financial decisions without unnecessary cost friction. Financial institutions serve as market intermediaries to generate revenues. As the Proposal's undue restrictions on market making make entering into financial instruments more expensive, returns for these financial institutions will fall and the cost will thus be passed on to individual investors.

The Proposal would unnecessarily increase these transaction costs through overly restrictive requirements designed to completely eliminate proprietary trading at all levels of banking entities' operations. The Proposal is unnecessarily intrusive through a combination of five elements:

1. The definition of "trading account" is far broader than required by the statute or intended by Congress and includes a presumption that any position held for 60 days or less was entered into with short-term intent. This broad definition brings the majority of a banking entity's trading activities within the Volcker framework, effectively presuming that they are prohibited unless specifically permitted through a narrow permitted activity.
2. All trading activity in the trading account must fit into a permitted activity, described in general terms in the statute but defined in the Proposal through a set of narrow, specific and prescriptive requirements. Implicit in the permitted activities is a negative presumption that a transaction does not satisfy the permitted activity unless proven otherwise.
3. To engage in a permitted activity, banking entities must comply with an expansive and burdensome compliance structure, including required policies and procedures that must be followed above and beyond the specific requirements of the permitted activity. If any of the many requirements is not satisfied, that permitted activity cannot be used.

4. Banking entities must report extensive quantitative metrics to the Agencies, many of which have not historically been captured.
5. Even if an activity fits within the narrow bounds of the relevant permitted activity, this activity could be prohibited if viewed as raising conflicts of interest or excessive risk, subjectively defined on a case-by-case basis.

The cumulative impact of these restrictions will raise transaction costs as well as suppress essential market making and hedging activities.

We suggest the Agencies take a different path. They should abandon these detailed restrictions and instead rely on reasonably designed policies and procedures, risk limits and monitoring and examinations supported by metrics.[5] This type of compliance structure would allow for flexibility in the ever-changing financial markets and would leverage banking entities' knowledge about the markets.

The result would be transaction costs lower than if the Proposal is adopted as written.

To remedy these problems and to keep transaction costs low, the Agencies should:

- prohibit activities for which the primary purpose is profiting from short-term price moves, apart from market making, hedging and other permitted activities;
- focus the definition of "trading account" on trading with a proprietary purpose without a presumption that 60 days implies a short-term purpose;
- within market making and hedging, consider whether the activity is purposeful positioning and whether the effect is providing liquidity or risk reduction; and
- rely on reasonably designed policies and procedures, risk limits and monitoring and examinations supported by metrics to identify purposeful proprietary trading or overly risky activities.

The Proposal could raise the cost of capital formation for U.S. corporations, making it more difficult to innovate and employ American workers.

The significant growth in U.S. productivity over the past several decades has been driven, in part, by the ability of U.S. corporations to efficiently raise money in the capital markets. The Proposal would raise the cost of such capital formation, making it more difficult for U.S. corporations to begin new projects and to hire new U.S. workers.

Corporations access capital markets in order to raise funds to engage in projects they believe are worthwhile but may not have the funds to invest in at the current time. These corporations sell access to future cash flow, either at a specific rate (fixed income) or through participation in the company's profits (equities) to investors who are looking for

[5] While we generally support the idea of metrics, we believe that the Agencies should eliminate the "Spread Profit and Loss" metric, which is overly complicated, will be hard to compute and will not provide the Agencies with useful information.

worthwhile investments. Financing transactions permit these corporations to begin innovative projects that create jobs.

When investors consider purchasing primary issuances from corporations, they weigh a number of factors. One important factor is whether the security can be resold in a liquid market. If not, investors will be far more reluctant to purchase the offering or will demand a far higher yield. As a result, capital formation is inextricably tied to the ability of investors to readily resell a purchased security to highly capitalized market makers. U.S. corporations will not be able to raise funds through offerings in financial markets that lack strong market makers. Restrictions on market making by banking entities will, therefore, likely reduce market liquidity, discourage investment, limit credit availability and increase the cost of capital for companies.

The market for convertible bonds illustrates these realities. Convertible bonds allow investors to ensure a specified return while sharing in the upside of a company's profits. The market for these securities is illiquid and depends on banking entities being willing to buy and sell convertible bonds to and from market participants. Banks' convertibles desks engage in customer facilitation through taking positions in convertible securities and hedging them. The lack of liquidity in these specialized instruments, however, often leaves the convertibles desk going long or short in order to satisfy customer demand. The convertibles desk may need to hold its position for some period of time in order to be able to resell it in an economical manner, which would be jeopardized by the Proposal's restrictions on market makers.

The Agencies must ensure that the market making permitted activity is broad enough to allow issuers to use instruments like convertible bonds to make issuances attractive to investors and therefore make funding cheaper.

To remedy these problems and to avoid impairing capital formation, the Agencies should:

- ensure that the market making-related permitted activity allows sufficient flexibility for banking entities to serve as market makers in a broad range of capital raising instruments, such as convertible and other corporate bonds.

The Proposal could limit the ability of U.S. corporations and banks to hedge their risks.

U.S. corporations use financial markets to hedge exogenous risks affecting commercial activities. For example, corporations hedge in the commodities markets to insulate themselves against changes in the underlying price of commodities and hedge in the foreign exchange markets to insulate themselves against changes in currency values. The Proposal's limitations on banking entities' market making and hedging activities will reduce the opportunity for corporations to hedge their risks.

For example, the Proposal aims to preserve banking entities' role in the commodities markets by excluding spot commodity positions from the definition of "covered financial position." The Proposal does not, however, extend this treatment to commodity futures, forwards or swaps. In restricting trading of commodity futures, forwards and swaps, the Proposal will make it harder for banking entities to provide these risk-mitigating contracts to corporations that use them to, for example, hedge against increased fuel prices. Without adequate hedging, costs will increase not only for these corporations but for the customers who buy their products.

Similarly, the Proposal excludes spot foreign exchange positions from the definition of "covered financial position." The Proposal does not extend this treatment to foreign exchange forwards and swaps, even though the significance and safety of foreign exchange forwards and swaps led the Treasury Secretary to propose an exemption for these products from regulation as "swaps" for most purposes. In restricting trading of foreign exchange forwards and swaps, the Proposal will make it harder for banking entities to provide these risk-mitigating contracts to corporations that wish to use them, for example, to protect against fluctuations in the value of a currency in which they make foreign sales.

The narrow definition of market making will also make it harder for banks to provide customized hedging contracts to corporations and other end users. Corporations may need an instrument specifically tailored to unique risks they face. The narrow definition of risk-mitigating hedging for banking entities in the Proposal will make it harder for these banking entities to help corporations and other end users hedge risks. As discussed below, the proposed restrictions on risk-mitigating hedging would make it harder and more expensive for banking entities to hedge, which will be passed on in increased transaction costs to customers. Limits on anticipatory hedging will prevent banking entities from preparing to accommodate customer demand. Often, customers will ask a banking entity to execute at a specific price such as the volume weighted price for the day) or in a specific size, such as a large block of equity securities, at a given time in the future. An equity desk may be willing to accommodate these customers because of the ability to enter into hedge positions that prepare them, once the promise is made, for the time at which the transaction is executed. The Proposal's limits on anticipatory hedging to "slightly before" the desk takes on the position would effectively prohibit the banking entity from accommodating these client requests.

To remedy these problems and to avoid limiting hedging, the Agencies should:

- extend the exclusion for commodities to commodity futures, forwards and swaps;
- extend the exclusion for spot foreign exchange to foreign exchange forwards and swaps;
- encourage banking entities to provide opportunities for end users to hedge commercial risk; and
- allow a banking entity to anticipatorily hedge a position for which they have promised specific price or size execution to a customer from the moment the promise is made, regardless of when execution will occur.

The Proposal could increase the volatility of the instruments that U.S. asset managers and corporations use on a daily basis for funding and operations needs, including Treasury securities and foreign exchange.

Congress recognized the importance of proprietary trading activity by banking entities in a number of key products and markets. By construing these exclusions and permitted activities extremely narrowly, the Agencies attempt to limit this proprietary trading, contrary to congressional intent.

As discussed above, the Agencies have excluded spot foreign exchange contracts, but not foreign exchange forwards and swaps, from the definition of "covered financial position." In failing to include derivatives on foreign exchange in the foreign exchange exemption, the Agencies have indirectly limited the extent to which banking entities can use the spot foreign exchange exemption.[6]

Similarly, the Agencies have not included derivatives on government obligations in the government obligations permitted activity. Congress explicitly permitted proprietary trading in government obligations to avoid disrupting the crucial U.S. and municipal bond markets. The Agencies did not, however, include derivatives on government obligations, including futures and swaps on U.S. Treasuries, within the scope of the permitted activity. In omitting futures and swaps on U.S. Treasuries, the Agencies indirectly limited trading in the U.S. Treasuries themselves, as the underlying instruments and derivatives on them are often traded in tandem. The result will be wider spreads and higher costs for all market participants. This will hinder use of government securities for liquidity purposes and will have harmful effects throughout the U.S. financial system.

To remedy these problems and to avoid increasing volatility, the Agencies should:

- expand the exclusion for foreign exchange instruments to include foreign exchange forwards, options and swaps; and
- expand the scope of government obligations permitted activity to include derivatives on government obligations.

The Proposal could increase systemic risk by driving capital from the markets and making it harder for banking entities to hedge these risks.

A primary goal of the Dodd-Frank Act is to decrease financial systemic risk. The Proposal would, in contrast to this key goal, increase financial systemic risk by encouraging less-capitalized and less-regulated financial institutions to take on activities that banking entities currently provide and by making it harder for banking entities to hedge their risks.

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[6] If the Agencies keep the distinction between foreign exchange spot and forward contracts, they should treat any foreign exchange spot transaction that settles within T + 5 as spot. Spot transactions effected globally generally settle within T + 5.

Implicit in the Proposal is the Agencies' belief that entities not affiliated with banks will step in and provide additional liquidity to the market to make up for the significantly decreased activities of banking entities. The Proposal does not indicate who these other financial institutions are and we see few candidates. The Agencies may believe that hedge funds will be able to step into these roles and serve as market makers. We believe this is a mistaken view for two reasons. First, as discussed above, serving as a market maker in anything but the most liquid equity securities requires that significant capital be committed to inventory that may be required to be held for a significant amount of time and would be difficult to liquidate into the market. Hedge funds are unlikely to commit this capital. Second, to the extent that hedge funds can serve as market makers in certain markets, hedge funds are significantly less regulated than banking entities. It seems at odds with the systemic risk-reducing aim of Dodd-Frank to push crucial market making activity away from transparent, highly-regulated banking entities to opaque, unregulated markets.

In addition, the narrowness of the hedging permitted activity exception will increase systemic risk by making it more difficult for banking entities to engage in prudent risk management. For example, the Proposal requires that instruments used for risk-mitigating hedging be "reasonably correlated" to the risk that is being hedged, but does not specify what constitutes reasonable correlation or how it is to be measured. This uncertainty is likely to chill legitimate hedging activity. Instead, hedging should be defined as any transaction that offsets risk in a trading book or any other permissible activity such as asset-liability management. Banking entities should be able to set hedging risk limits and permit hedging activities within those limits, rather than looking at the correlation of a hedging instrument to the underlying risk.

Similarly, the requirement that a hedge not expose the banking entity to any new risk at the time the hedge is entered into is inconsistent with prudent risk management. In many cases, such as hedging of interest rate or foreign exchange instruments along the yield curve, it is necessary to take one kind of risk (*e.g.*, yield curve risk) to hedge others. In addition, many trades expose the banking entity to credit risk it did not have before the trade. The Proposal should explicitly provide that such new risks do not disqualify an otherwise valid hedging position.

Finally, while the Proposal intimates that banking entities should not be profiting from risk-mitigating hedging, it is unclear where permitted hedging with economical instruments ends and prohibited profiting begins. Banking entities should be encouraged into, rather than discouraged from, hedging with the most cost-effective instruments.

To remedy these problems and to avoid increasing systemic risk, the Agencies should:

- allow banking entities to remain the effective market makers in financial markets;
- allow trading units to set hedging risk limits and permit hedging activities within those limits, rather than scrutinizing the correlation of a hedging instrument to the underlying risk;
- remove the requirement that a hedge not expose the banking entity to any significant new risk at the time the hedge is applied; and
- clarify that hedging using the cheapest instrument is permissible hedging, rather than impermissible arbitrage, as long as the hedge otherwise meets the permitted activity requirements.

The Proposal could decrease market efficiency, reduce price transparency and increase market volatility by reducing beneficial arbitrage.

The U.S. capital markets rely on arbitrage activities to keep in line the prices of related instruments. The Proposal's exclusion of arbitrage activities from the market making permitted activity is overly simplistic and will harm the efficiency of the financial markets.

For example, the market for exchange-traded funds ("**ETFs**") relies on the arbitrage activities of banking entities. ETFs allow an investor to trade the equivalent of a basket of stocks, making them particularly useful in turbulent times when it may be difficult to trade many stocks individually. For this market to function, the price of the ETF must match its underlying portfolio value. Part of the success of this market over the past several years can be attributed to the fact that banking entities have actively engaged in arbitrage that keeps the price of the ETF close to its fundamental value.

Arbitrage activities also help promote market stability. Increased liquidity over the past decade has reduced average trade size, lowered volatility and helped narrow bid-ask spreads, making investments cheaper and more stable for market participants. In particular, while average daily volumes have roughly tripled since 2000, volatility has declined (with the exception of during the financial crisis) and the quoted size at the national best bid and offer has increased since 2004. Similarly, statistical arbitrage helps calm otherwise volatile markets by providing liquidity into supply or demand imbalances, and event arbitrage helps provide liquidity when significant liquidity is needed around a market event.[7]

To remedy these problems and to avoid decreasing market efficiency, the Agencies should:

- remove from the Proposal indications that arbitrage trading by banking entities is prohibited; and
- explicitly allow banking entities to engage in arbitrage activity that aligns prices and therefore increases market efficiency, such as index arbitrage, ETF arbitrage, statistical arbitrage and event arbitrage.

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[7] *See* Credit Suisse, Sizing Up U.S. Equity Microstructure, AES Analysis, April 22, 2010.

The Proposal could dislocate markets, with possible permanent negative effects, by phasing in requirements faster than intended by Congress.

Major changes to the structure of financial markets require significant phase-in periods to ensure that dislocations do not occur, which can significantly increase prices and risks.

Congress understood the importance of a gradual phase-in for the Volcker Rule. Dodd-Frank required regulators to adopt final regulations implementing the Volcker Rule within 180 days after the Financial Stability Oversight Council's study, or October 18, 2011. While this deadline may have been unduly aggressive, the Agencies did not even propose regulations until October 11, 2011 and the CFTC only recently released its proposal. Because comments on the Proposal are not due until February 13, 2012 and the Agencies will need to carefully review the comments and incorporate them into a final draft, it seems very unlikely that final regulations would be adopted before, at the earliest, late April 2012.

Fortunately, Congress incorporated a two-year conformance period into the Volcker Rule statutory text. In the Proposal, however, the Agencies have effectively curtailed this conformance period and moved the Volcker compliance date to July 21, 2012. First, the Agencies have required that banking entities have the required compliance and metrics reporting infrastructure in place by July 21, 2012, a nearly impossible task given the compressed timeline. Second, and perhaps more problematic, the Agencies note in the Proposal that they "expect a banking entity to fully conform all investments and activities to the requirements of the proposed rule as soon as practicable within the conformance periods ..."

As a result, although Congress expected banking entities to have more than two and a half years (from October 2011 to July 2014) to understand the Agencies' regulations and gradually change their market activities to allow the post-Volcker market to come into effect with minimal disruption, instead, banking agencies will have, at most, [three] months ([April] 2012 to July 2012) to do so, less than an eighth of the time that Congress meant to allot.

To remedy these problems and to avoid market dislocations, the Agencies should:

- not require metrics and compliance structures until one year after adoption of the final regulations; and
- explicitly state that banking entities have the entirety of the two-year conformance period to comply with the Volcker Rule regulations.

The Proposal unduly restricts conduct permitted "solely outside of the United States"

Congress deliberately and appropriately limited the extraterritorial effects of the Volcker Rule by enacting the Non-U.S. Trading and Fund Provisions. These provisions permit international banks to engage in proprietary trading, and to sponsor and invest in "covered funds" pursuant to BHCA Section 4(c)(9) or 4(c)(13) solely outside of the

United States. As described below, the scope of the exemptions in the statutory text focuses on the location of the activities a bank engages in as principal that would incur risk (i.e., trading, investing or sponsoring). The statute's plain meaning should not be expanded to prohibit reliance on the Non-U.S. Trading and Fund Provisions where there is any U.S. nexus related to such activity (for example, U.S. securities or U.S. counterparties).

Congress intended the Non-U.S. Trading and Fund Provisions to be implemented in a manner consistent with prior regulatory practice and with longstanding principles of international comity and deference to home-country prudential regulation of international banks. Ample evidence of this intent exists in the legislative history of the Volcker Rule. For example:

- Senator Merkley, a principal author and sponsor of the Volcker Rule, explained that the Non-U.S. Trading and Fund Provisions "recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law."[8]

- Senator Hagan expressed her understanding in the Congressional Record that the Non-U.S. Fund Provisions would be implemented according to the Federal Reserve's existing precedents and practices under Sections 4(c)(9) and 4(c)(13) of the BHCA.[9]

If implemented properly in accordance with expressed congressional intent, the Non-U.S. Trading and Fund Provisions would defer judgments about the appropriate scope of activities outside the United States to the governments and supervisors of the relevant jurisdictions, which have made and will continue to make their own judgments about which proprietary trading and fund activities banks should be permitted to conduct.[10]

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8 Merkley-Levin Colloquy at S5897.

9 See 156 Cong. Rec. S5889-S5890 (daily ed. July 15, 2010) (statement of Sen. Hagan) ("For consistency's sake, I would expect that, apart from the U.S. marketing restrictions, [the Non-U.S. Fund Provisions] will be applied by the regulators in conformity with and incorporating the Federal Reserve's current precedents, rulings, positions, and practices under sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act so as to provide greater certainty and utilize the established legal framework for funds operated by bank holding companies outside of the United States.").

10 Other G-20 countries are actively debating the appropriate regulatory treatment of institutions that combine proprietary/investment banking activities and retail banking. If the Volcker Rule were applied—beyond its plain meaning—to reach international banks' non-U.S. trading and fund activities, it could result in the imposition of overlapping and inconsistent regulatory regimes on these institutions' non-U.S. operations. See, e.g., U.K. Independent Commission on Banking, Final Report: Recommendations (Sept. 12, 2011) (recommending adoption of a "retail ring-fence" after discussing other structural reform options for universal banking, including the Volcker Rule, full separation of retail and investment/wholesale banking, and operational subsidiarization). For similar reasons, we would generally support limiting the extraterritorial reach of the Volcker Rule as applied to U.S. banks to provide appropriate flexibility to engage in activities outside the United States permitted by host country laws and regulations.

The scope of the Non-U.S. Trading provision must be understood in the context of the original purpose of the Volcker Rule—limiting risks to institutions that benefit from the federal safety net. The Volcker Rule's focus on risk and safety and soundness of the U.S. financial system strongly supports appropriate exemptions for non-U.S. activities that do not implicate the federal safety net, safety and soundness of U.S. institutions, or U.S. financial stability generally. When implementing the Volcker Rule for international banks, the Agencies should use these objectives as guiding principles and should focus the geographic scope of the Final Rule on the location of the risk-taking activity itself (and not, except as may be specifically required by the Volcker Rule, on the location of other activities).

In our view, the Proposed Rule's implementation of the Non-U.S. Trading and Fund Provisions would inappropriately expand the scope of the statute by interpreting "solely outside of the United States" to prohibit activities with connections to the United States that have no bearing on the location of the risk-taking activity. This approach is not consistent with congressional intent, as evidenced by the congressional statements cited above and by the revisions to the statutory text of the Volcker Rule during the legislative process. Early drafts of the Volcker Rule would have required an "investment or activity" relying on the equivalent exemption for non-U.S. activities to be conducted "solely outside of the United States".[11] In the final statutory text, however, the Non-U.S. Trading and Fund Provisions focus on specifically identified actions taken as principal that could create risk for a banking entity:

- The Non-U.S. Trading Provisions permit "<u>proprietary trading</u> . . . provided that the <u>trading</u> occurs solely outside of the United States".[12] Proprietary trading, in turn, is specifically defined as "engaging <u>as principal</u> for the trading account" of a banking entity, clarifying that it is the action taken <u>as principal</u> that is regulated, and not other activities such as the actions of agents or counterparties.[13]

The narrowing of the limitations on these exemptions from "activities" to specifically identified actions taken as principal (trading, investment or sponsorship) illustrates Congress's intent to focus on the location of the risk-generating activity, and not on other activities unrelated to the location of principal risk.

Under the Agencies' proposed approach, all foreign trading with U.S. counterparties or on U.S. exchanges/execution facilities would be subject to the operation of the Volcker Rule, as would any foreign trading in which a U.S. employee of an international bank played a direct role, regardless of whether the activity presented any risk to U.S. taxpayers or U.S. financial stability. The practical impact of this narrow interpretation is likely to be reduced liquidity in U.S. markets and securities, migration of trading activities to other financial centers outside of the United States, and the development of

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11 <u>See, e.g.</u>, The Restoring American Financial Stability Act of 2010, S. 3217, 111th Congress § 619 (as reported by the S. Comm. on Banking, April 29, 2010).

12 BHCA § 13(d)(1)(H) (emphasis added).

13 <u>Id</u>. at (h)(4) (emphasis added).

alternative trading platforms outside of the United States, all of which are likely to lead to job losses within the United States. This loss of U.S. jobs would come without any offsetting reduction in the risk to the U.S. financial markets or U.S. taxpayers, because whether or not a U.S. agent or broker is involved in a transaction, the non-U.S. operations of international banks bear the risk of these activities overseas, and such operations are not eligible for U.S. government support.

In addition, even though a portion of the trading outside of the United States involving U.S. counterparties would be permissible under the market-making or other exemptions, reliance on those exemptions would entail onerous reporting and compliance obligations. The marginal costs imposed by the Volcker Rule on a bank as a consequence of specific, discrete activities may in many cases render those activities no longer economically viable.[14] As a result, if they are unable to rely on the Non-U.S. Trading Provisions, many international banks' non-U.S. affiliates are likely to cease trading with U.S. counterparties and on U.S. exchanges, decreasing liquidity in the U.S. market without any corresponding benefit for U.S. financial stability or the safety and soundness of U.S. banking operations.

We urge the Agencies to implement the Non-U.S. Trading and Fund Provisions in the Final Rule in a manner that focuses more appropriately on the location of the risk-taking activity targeted by the Volcker Rule, and not on other factors not required by the terms or intent of the statute.

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Credit Suisse appreciates the opportunity to provide comments on the Proposal. Please feel free to contact Joseph L. Seidel at (202) 626-3302 or Michael W. Williams at (202) 626-3316 with any questions.

Respectfully submitted,

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14 For example, an international bank may decide to shut down certain U.S. facing market-making activities, or close a branch in the United States, if those activities expose the bank as a whole to compliance costs that are greater than the revenues generated by the specific activities.

Appendix A

Specific Suggestions to Mitigate Harmful Impacts

The Proposal could decrease liquidity in the financial markets.

To avoid decreasing liquidity, the Agencies should:

- recognize fully the differences for market makers between liquid and illiquid markets;
- limit the prohibition on generating significant revenues from, and compensating market making traders based on, changes in the price of a financial instrument;
- explicitly define "customer" to include any counterparty to whom a banking entity is providing liquidity;
- allow market makers to build inventory in products where they believe customer demand will exist, regardless of whether the inventory can be tied to a particular customer in the near-term; and
- encourage market making-related hedging.

The Proposal could, through its overly burdensome attempts to root out all proprietary trading, increase transaction costs for asset managers and corporations.

To keep transaction costs low, the Agencies should:

- prohibit activities for which the primary purpose is profiting from short-term price moves, apart from market making, hedging and other permitted activities;
- focus the definition of "trading account" on trading with a proprietary purpose without a presumption that 60 days implies a short-term purpose;
- within market making and hedging, consider whether the activity is purposeful positioning and whether the effect is providing liquidity or risk reduction; and
- rely on reasonably designed policies and procedures, risk limits and monitoring and examinations supported by metrics to identify purposeful proprietary trading or overly risky activities.

The Proposal could raise the cost of capital formation for U.S. corporations, making it more difficult to innovate and employ American workers.

To avoid impairing capital formation, the Agencies should:

- ensure that the market making-related permitted activity allows sufficient flexibility for banking entities to serve as market makers in a broad range of capital raising instruments, such as convertible and other corporate bonds.

The Proposal could limit the ability of U.S. corporations and banks to hedge their risks.

To avoid limiting hedging, the Agencies should:

- extend the exclusion for commodities to commodity futures, forwards and swaps;
- extend the exclusion for spot foreign exchange to foreign exchange forwards and swaps;
- encourage banking entities to provide opportunities for end users to hedge commercial risk; and
- permit a banking entity to anticipatorily hedge a position for which they have promised specific price or size execution to a customer from the moment the promise is made, regardless of when execution will occur.

The Proposal could increase the volatility of the instruments that U.S. asset managers and corporations use on a daily basis for funding and operations needs, including Treasury securities and foreign exchange.

To avoid increasing volatility, the Agencies should:

- expand the exclusion for foreign exchange instruments to include foreign exchange forwards, options and swaps; and
- expand the scope of government obligations permitted activity to include derivatives on government obligations.

The Proposal could increase systemic risk by driving capital from the markets and making it harder for banking entities to hedge these risks.

To avoid increasing systemic risk, the Agencies should:

- allow banking entities to remain the effective market makers in financial markets;
- allow trading units to set hedging risk limits and permit hedging activities within those limits, rather than scrutinizing the correlation of a hedging instrument to the underlying risk;
- remove the requirement that a hedge not expose the banking entity to any significant new risk at the time the hedge is entered into; and
- clarify that hedging using the cheapest instrument is permissible hedging, rather than impermissible arbitrage, as long as the hedge otherwise meets the permitted activity requirements.

The Proposal could decrease market efficiency, reduce price transparency and increase market volatility by reducing beneficial arbitrage.

To avoid decreasing market efficiency, the Agencies should:

- remove from the Proposal indications that arbitrage trading by banking entities is prohibited; and
- explicitly allow banking entities to engage in arbitrage activity that aligns prices and therefore increases market efficiency, such as index arbitrage, ETF arbitrage, statistical arbitrage and event arbitrage.

The Proposal could dislocate markets, with possible permanent negative effects, by phasing in requirements faster than intended by Congress.

To remedy these problems to avoid market dislocations, the Agencies should:

- not require metrics and compliance structures until one year after adoption of the final regulations; and
- explicitly state that banking entities have the entirety of the two-year conformance period to comply with the Volcker Rule regulations.