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February 13, 2012

The Honorable Ben S. Bernake
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., NW
Washington, DC 20551

The Honorable John G. Walsh
Acting Comptroller of the Currency
Department of the Treasury
250 E St, SW
Washington, DC 20219

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th St., NW
Washington, DC 20429

The Honorable Mary L. Schapiro
Chair
Securities & Exchange Commission
100 F St., NE
Washington, DC 20549-1090

By Electronic Submission

Re: Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds (FRS Docket No. R-1432 & RIN 7100 AD 82; OCC Docket ID OCC-2011-14; FDIC RIN 3064-AD 85; SEC File Number S7-41-11; CFTC RIN 3038-AD05).

Dear Sirs and Madam:

The American Council of Life Insurers ("ACLI") is a national trade association with over 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry. ACLI has provided constructive input on numerous proposed rulemakings implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank

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Act").[1] ACLI appreciates the opportunity to respond to the Notice of Proposed Rulemaking defining the Prohibitions and Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds under Section 619 of the Dodd-Frank Act (the "Proposed Regulations"). The Agencies' extension of the initial comment period in December facilitated more thorough analysis and input on the proposal.

The Proposed Regulations are vitally important to life insurers as institutional investors in the securities markets. Although the proposed proprietary trading constraints principally affect banks, these initiatives could have an adverse secondary impact on life insurers by reducing market making, liquidity and depth in the securities markets. We address these concerns in greater detail below.

I. Introduction

12 U.S.C. §1851 (the "Volcker Rule") is among the most important and complex provisions of the Dodd-Frank Act. As the Agencies have recognized in the preamble to the Proposed Regulations, implementation of the Volcker Rule through the rulemaking process involves an intricate analysis of the statutory provisions, including subtle but important distinctions among activities that permit banking entities "to continue to provide client-oriented financial services."[2] The preamble further observed that the Proposed Regulations must appropriately consider the interests of a banking entity in preserving its ability "to continue to structure its businesses and manage its risks in a safe and sound manner." The preamble also notes that there are many additional areas where greater clarity will be necessary or desirable, particularly concerning exemptions and the scope of prohibitions.

We acknowledge the efforts of the Agencies, as reflected in the Proposed Regulations, to identify areas that require greater clarity and to provide appropriate latitude to banking entities' continued ability to provide client-oriented services. Recognition of the need and desirability of providing client-oriented services is crucial not only to the banking entities, but even more importantly to their clients and to the overall markets. The efficient functioning of the markets, including those relied upon by institutional investors, requires that banking entities be permitted to provide market making and other client-driven services.

Life insurers have over $3.1 trillion of assets under management in their general accounts, with fixed income investments comprising over $2.2 trillion of that amount.[3] To satisfy obligations to policyholders, life insurers typically manage highly diversified fixed income portfolios, with investments across almost all asset sectors and rating categories. Many of our member companies are also active end-users of financial derivatives, which they use responsibly to hedge the risk associated with investment assets and insurance product liabilities. Insurance companies' continued ability to manage fixed income investments and to utilize derivative hedges is critically important to their asset and liability risk management, and is essential to offering customers a broad range of affordable insurance products.

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[1] *See, e.g.*, ACLI initial comment letter on prohibitions and restrictions on proprietary trading (Jan. 24, 2012) [http://sec.gov/comments/s7-41-11/s74111-81.pdf] ; ACLI comment letter on the definition of the term "swap" (July 22, 2011) [http://comments.cftc.gov/publiccomments/viewcomment.aspx?id=47894&searchtext] ; ACLI comment letter on the definition of major swap participant (Feb. 22, 2011) [http://sec.gov/comments/s7-39-10/s73910-73.pdf] ; ACLI comment letter to five regulators on collateral and margin for covered swap entities (July 11, 2011) [http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47742&SearchText=wilkerson] .

[2] Proposed Regulations, Supplementary Information, Part II A.

[3] These figures are calculated as of December 31, 2010.

Financial market participants have identified the impact the Volcker Rule on overall liquidity in the marketplace, particularly in the fixed income markets, as a primary concern. As important long-term investors in the financial markets, life insurers are confident that the Volcker Rule can achieve its proprietary trading objectives without impairing efficient securities markets. We urge the Agencies to gradually phase-in the requirements to mitigate transitional disruptions and to carefully consider the impact of the Volker Rule on institutional investors that depend on active market making and liquidity.

II. Summary of Position

ACLI recognizes the public policy supporting the Volcker Rule, supports its goal of restricting the ability of banking entities to engage in proprietary trading, and acknowledges the thorough consideration that the Agencies in developing the Proposed Regulations. The Volcker Rule itself recognizes and distinguishes market making from proprietary trading by specifically identifying market making as a permitted activity. We are quite concerned, however, that the Proposed Regulations implement the Volcker Rule's market making exception in a very restrictive way and would severely undermine market liquidity in the fixed income markets. To the extent the Proposed Regulations impede an insurance company's ability to manage its fixed income portfolio and to enter into and manage hedging transactions, the direct and indirect costs of reduced liquidity could ultimately cause higher premiums for customers or reduced product options and features. We believe these unintended consequences in the Proposed Regulations deserve careful consideration and merit a reasonable solution.

III. Importance of Fixed Income Market Making to Insurance Company Investors and their Policyholders

Market makers play an important role in ensuring that fixed income markets function smoothly. Their willingness to step into the opposite side of a trade is an essential part of making sure that there is proper liquidity in the capital markets. This is especially true during times of market stress. We are in agreement with the description of market making contained in the Proposed Regulation's "Appendix B: Commentary Regarding Identification of Permitted Market Making-Related Activities" ("Appendix B").

When a dealer commits capital to buy or sell securities, such dealer can be considered engaged in principal trading. Principal trading involves price making and provides market liquidity. Unlike proprietary traders, market makers, while involved in principal trading, have customers (as Appendix B, Section III, Part A indicates) and are expected to provide liquidity to those customers, even in distressed markets. In the principal trading model, the market maker acquires inventory for the benefit of its customers. Since market makers hold this inventory to meet expected client demand from customers desiring to buy, or because they purchase securities from customers desiring to sell, the market maker is exposed to risk from changes in the price of that security. A principal trader may make or lose money based on the management of that risk. Virtually all fixed income securities are traded in this manner. The description of market making in Appendix B, Section III, Part A is consistent with our view of how the fixed income markets work, particularly with respect to how that discussion relates to the intermediation role a market maker must play in an "over-the-counter" market.

The fixed income market operates as an over-the-counter market, comprised of a vast number of different issuers and issues. For example, in the U.S. Credit Index (reflecting $4 trillion of debt), there are approximately 800 issuers. 302 of those issuers have outstanding index eligible debt of $1 billion or less with a total amount outstanding for such issuers of approximately $150 billion.

The U.S. Credit index has 4,672 issues, with about 6 issues per issuer. Today's fixed income market requires covered banking entities to act as principals and provide intermediation services. The vast breadth and complexity of the market makes a transition to an "agent" market (such as the equity exchanges) not viable. And today's fixed income market requires that, as set forth in Appendix B, Section I, Part A, "in order to provide effective intermediation services, market makers are required to retain at least some risk for at least some period of time with respect to price movements of retained principal positions and risks." We explain our strong concerns that the provisions in the Proposed Regulations may not fully recognize and enable market makers to reasonably take such principal positions and risks, and that may make it impossible for a principal fixed income market to continue to function and provide liquidity as it has historically done.

While insurance company investors rely on market makers in multiple ways, the key underlying theme is a long-term and consistent commitment by a market maker who must meet rigorous counterparty approval requirements. This commitment, of resources, time and capital, is reflected in a number of ways. First, life insurers expect that a market maker will carry sufficient inventory to ensure that it can offer bonds that meet our investment needs. This allows life insurers to invest their funds in a timely manner, quickly matching our assets with our liabilities. Life insurers also expect market makers to commit sufficient capital to allow them to bid on bonds that they desire to sell. This provision of liquidity allows life insurers to sell bonds both to manage the credit risk in their portfolios, as well as achieve liquidity to fund benefit outflows. When needed, life insurers expect (and need) market makers to bid on sizeable bond positions. There are no alternatives to trading these large position sizes other than through market makers who are willing to commit requisite capital in a principal transaction.

IV. Reduction of Market Liquidity and its Impact

We are highly concerned that the Proposed Regulations would significantly interfere with principal transactions in market making, primarily because covered banking entities will be unable to readily determine if their market making practices will remain lawful under the Proposed Regulations. Many observers believe that the Proposed Regulations will greatly discourage the further commitment of capital on a principal trading basis by covered banking entities. If, as we would expect, covered banking entities revert to an agented, "special order" style trading system, liquidity will invariably be reduced and negatively impair issuers and investors in the fixed income market.

Lower liquidity in the market would most likely result in higher costs for issuers of debt, as investors will need to be compensated for buying less liquid securities. This cost will vary depending on the credit quality of the issuer, the amount of debt the issuer has in the market and the maturity of the security. For well-known, high quality issuers this cost may be small. Unfortunately, for lesser known or lower quality issuers this cost may be significant and in some cases prohibitive. The cost to corporate issuers, for example, of this increase in yields has been estimated to be $3 to $6 billion per year.[4]

Importantly, any yield increases will have a compounding effect as outstanding debt matures and new debt must be priced at higher spreads. These higher borrowing costs or in some cases the lack of debt availability, will have a dampening effect on the economy, potentially leading to lower capital formation and an adverse impact on job growth. A leading strength of the U.S. financial system, as opposed to those in other parts of the world, has been the depth of its capital markets. Changes that would have an adverse impact on these markets must be carefully considered. Lower

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[4] *See*, Oliver Wyman, ***The Volcker Rule Restrictions on Proprietary Trading – Implications for the US Corporate Bond Market*** (December 2011) [http://www.sifma.org/issues/item.aspx?id=8589936887] ("Oliver Wyman Study").

market liquidity will also have a profound impact on investors in the debt markets. As mentioned above, life insurers' involvement in the debt capital markets is the result of their need to effectively match assets and liabilities. This process ensures that life insurers can fulfill their long-term promises to policyholders. Lower liquidity in the debt markets will impact life insurers in several significant ways.

First, investors will demand higher spreads in order to compensate for this lower liquidity. This new "liquidity premium" will result in an almost instantaneous decline in the value of investments currently held by life insurers. The overall impact of this on the corporate bond market alone is estimated to be $300 billion.[5] Second, transaction costs will increase as bid-offer spreads increase to compensate for this shift in liquidity. Third, long-term investors, such as insurance companies, will be forced to keep their portfolios more liquid and avoid positions that will be harder to sell during credit downturns. This risk avoidance is one reason some borrowers may lose access to the market.

Finally, we believe that the Proposed Regulations, as currently written, will also limit life insurers' ability to use derivatives to hedge their risks. This consequence occurs because the firms with whom life insurers trade will be less willing to enter into derivative trades if they cannot hedge these positions with other market participants or otherwise find that the market making positions they establish to make these trades may not be permissible under the Proposed Regulations. We expect that the cumulative impact of the issues highlighted above may cause higher priced products and lower returns for policyholders. These consequences may prevent some customers from purchasing the insurance and retirement products that are so important for their financial security.

V. Specific Concerns with the Proposed Regulations

We appreciate the input elicited by many questions raised in the Proposal. We will not offer an exhaustive list of suggested changes and drafting modifications, leaving certain aspects of the discussion for other market participants better suited to address them. For the reasons explained below, we respectfully raise the following concerns with the Proposed Regulations, which would be consistent with the Volcker Rule and the discussion of market making reflected in Appendix B.

A. Restrictive Scope of "Permitted Activity" Exclusion from Market Making Definition

Volcker Rule clause (a)(1)(A) states that unless otherwise provided in the statute, a banking entity cannot engage in proprietary trading. Volcker Rule clause (d)(1)(B) provides as a "permitted activity" the purchase, sale, acquisition or disposition of securities "in connection with underwriting or market-making-related activities, to the extent that any such activities … are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." Our concern is that the Proposed Regulations take a very narrow and prescriptive approach to implementing that exception. The Proposed Regulations have specific criteria that apply equally across all asset classes and market conditions, which must ***each*** be met in order for an activity to qualify as permissible market making.

- Some of the criteria that must be met include –
  - o Two-sided markets on a ***regular or continuous*** basis (Sec. __.4(b)(2)(ii)) – may not be applicable in all markets.

[5] Oliver Wyman Study.

  - Example: A highly structured, negotiated transaction with an insurance company to hedge its variable annuity portfolio presents a classic example of a client facing market making activity that is both initiated by, and beneficial to, clients. However, this type of transaction may not meet the criteria for regular or continuous quoting.

- Activity designed not to exceed ***reasonably expected near-term client, customer and counterparty demand*** (Sec. __.4(b)(2)(iii)) – may be difficult to quantify since the determination of which securities are to be bought and sold and the timing of those transactions is customer driven. Moreover, application of this criterion may also discourage holding inventory on which long-term investors rely for portfolio management purposes. We believe this requirement should be interpreted in accordance with the spirit of the Volcker Rule exception to allow market making activity, as it exists today, to continue. Part of the service "buy side" customers require is the ability to immediately sell a security whether due to liquidity needs or credit management. These types of transactions where customers can "hit the bid" are available in the market today and can only continue to exist if the covered banking entities can continue to commit the necessary capital.

  - Example: A concentrated large trade of a customer that has the potential to move the market would normally be intermediated by a market maker willing to hold the position and work out of it over time. However, the market maker will have to determine whether holding such a position in inventory would meet the criteria of near-term customer demand. If a market maker has to quickly sell out of the position, efficient intermediation of these types of trades may be limited – either with worse prices or an unwillingness to enter into the trade and the likely result of a move towards an agent market that will reduce liquidity.

- Activities of a trading unit must be designed to generate revenues ***primarily from fees, commissions, and bid/ask spreads***, or other income not attributable to appreciation in value of covered financial positions (Sec. __.4(b)(2)(v)) – does not fully recognize that the market maker must hold inventory, which may increase or decrease in value, until a natural buyer appears.

  - Example: Market makers will offer more for an illiquid bond if they know that they can hold that bond until the other side of the trade naturally surfaces. If the trader is required to sell that bond within an artificially prescribed period, he will naturally pay significantly less to acquire the bond, shifting time risk back to the client. This requirement of income generation is not set forth in the statute and sets forth very limiting parameters that could be expected to have a severe dampening effect on how this market works.

- Aspects of the rule do not recognize that interdealer trading helps provide deep and liquid markets, indirectly facilitates customer trades, and helps dealers efficiently hedge their risks. Because not all customers and end users have a relationship with every dealer, interdealer trading creates a hub-and-spoke system, allowing customers of different dealers to be linked through interdealer transactions which help to expand overall inventory and the liquidity of the markets. The rule should explicitly recognize that interdealer trading is an important part of market making activities.

B. Orderly Implementation of the Proposed Rules

We urge the Agencies to carefully evaluate the process for implementing the final regulations, especially in light of the initiatives' potential risk to the markets and the concomitant impact on the economy. The Volcker Rule should be rolled out in a measured and incremental way, especially given the significant impact the rule will have on the fixed income markets. In addition, we believe that phasing in the requirements gradually will allow the Agencies and covered banking entities to allocate resources in an effective manner, and will serve to mitigate the risks of market disruption for issuers and investors alike. This could include, over time, new entrants with sufficient capital and risk management procedures that would meet life insurers' rigorous counterparty approval requirements.

VI. Recommendations

As a general matter, ACLI urges the Agencies to revise the Proposed Regulations so that the resulting final regulations focus on general guidelines rather than strict and rigid criteria. This approach fulfills the Volcker Rule and the spirit reflected by Appendix B. In considering the revisions to the Proposed Regulations, we ask the Agencies to address three factors that could greatly inhibit market making: (i) the very restrictive nature of the Proposed Regulations, (ii) that the Proposed Regulations are applied at the trade level which may have been the intent of the Agencies, and (iii) that a determination as to whether an activity is permissible appears to be a backward looking analysis rather than considering the reasonable expectations of the parties at the time they enter into a transaction, given that markets are uncertain and it is typical to focus on establishing an effective investment process because not every investment will perform favorably.

Additionally, ACLI offers the following specific recommendations:

1) "**Portfolio" Approach**. Please consider revising the Proposed Regulations to ensure that the guidelines and criteria to determine market making are done on a portfolio, as opposed to a "trade-by-trade," approach. Our member companies typically manage highly diversified fixed income portfolios and understand firsthand the importance of considering the risk and positioning of the entire portfolio, rather than focusing solely on how any one trade would behave. As a result, the final regulations should focus on the portfolio level rather than the trade level, which often misses the larger picture.

   A simple example demonstrates this potential concern. Companies that own corporate bonds often hedge the risk of those securities by hedging the credit risk with a credit default swap and hedging the interest rate risk with a Treasury future. Looking at any one of those three components (the corporate bond, the credit default swap, or the Treasury future) individually presents a certain risk profile which is quite different from the risk profile of the three components considered together. Accordingly, we strongly favor a portfolio-based approach to the final regulations, which is achievable and consistent with the Volcker Rule and the intent recently expressed by the Agencies.

2) **Development of Market Making "Plan."** The Volcker Rule and the commentary expressed in Appendix B supports an approach enabling a specific covered banking entity to work together with the Agencies to develop an individualized plan within which such covered banking entity could safely pursue its market making activities. This plan could identify, among other metrics, targeted inventory aging and level guidelines,

capital commitment targets and permissible buckets for liquid bonds evidenced by Trace data. The plans should not take a "one-size-fits-all approach," but should instead recognize that different covered banking entities approach their businesses in different fashions, with different product types and different risk profiles. Having a variety of approved plans will likely help Agencies develop better insight into the relevant risks and the means of managing it, while achieving more tailored approaches so that covered banking entities can appropriately deal with market developments.

An approved and jointly developed plan seems reasonable and is not inconsistent with regulatory oversight arrangements our members have with their state insurance regulators, such as derivatives use plans[6] or other derivatives guidelines under state insurance laws and regulations. It would be constructive for the Agencies to review these models under state insurance regulation for feasibility and inclusion as part of the Proposed Regulations.

VII. Conclusion

We greatly appreciate your attention to our views, and acknowledge the Agencies' commendable effort in developing the Proposed Regulations. We are particularly grateful for the opportunity to provide input on the Proposed Rules, given the significant effect the initiative will have on our business and on the customers who rely on our products to secure their financial futures. Please let me know if any questions develop, or if we can provide additional information.

Sincerely,

Carl B. Wilkerson

Carl B. Wilkerson

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[6] *See*, for example, the provisions under New York insurance laws requiring each life insurer to submit a detailed derivatives use plan authorized and approved by the life insurer's board of directors, and approved by the Superintendent of Insurance at NY Insurance Law § 1410 (Derivative Transactions and Derivative Instruments) (2012); [27 McKinney's Consolidated Laws of New York Annotated §1410, 2012 Cumulative Pocket Part at 177 (2012)].