

February 13, 2012

Via Electronic Mail

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

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE.
Washington, DC 20549-1090
File No. S7-41-11

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve
System
20th Street and Constitution Avenue, NW.
Washington, DC 20551
Docket No. R-1432
RIN: 7100 AD 82

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

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

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

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. ("Goldman Sachs" or "we") appreciates the opportunity to comment on the proposed rule (the "Proposed Rule") in the notice of proposed rulemaking issued by the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC") and the Securities and Exchange Commission (the "SEC") and the notice of proposed rulemaking issued by the Commodity

Futures Trading Commission (the “CFTC” and, together with the OCC, the Federal Reserve, the FDIC and the SEC, the “Agencies”) to implement the restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds contained in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).¹ These restrictions are referred to as the “Volcker Rule.”²

This letter focuses on the proprietary trading prohibition of the Proposed Rule.³ We are submitting a separate letter on the hedge fund and private equity fund provisions of the Proposed Rule.

INTRODUCTION

We recognize that translating the statutory language of the Volcker Rule into workable regulations is quite a challenge. We appreciate the effort that the Agencies have made to strike a balance between flexibility and specificity with respect to its proprietary trading restrictions. These restrictions call for banking entities and their regulators to distinguish between prohibited proprietary trading and critically important—and statutorily protected—market making-related, underwriting and hedging activities.

The Proposed Rule acknowledges this challenge by asking the right questions. It has already led to a productive dialogue among the Agencies, the industry and market participants, including not only the banking entities subject to the Volcker Rule, but also our customers, who rely on the vital financial intermediation and capital-raising services that banking entities such as Goldman Sachs provide.

We have carefully reviewed the Proposed Rule and considered its potential consequences. To qualify as permitted market making-related, underwriting or hedging activity under the Proposed Rule, trading activity must satisfy numerous requirements. To qualify as market making-related, for example, there are seven independent criteria that are set forth in the Proposed Rule, each of which must be met. Quantitative trading metrics—calculations that, in context, can be helpful for indicating the character of trading activity—are only one part of one of these seven criteria. As we explain in more detail in this letter, we believe quantitative trading metrics are the single most valuable tool available to regulators for distinguishing between prohibited and permitted activities. A compliance program structured around metrics, if designed and implemented appropriately, will be robust and flexible. Metrics can be tailored to

¹ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (proposed Nov. 7, 2011) (OCC, Federal Reserve, FDIC and SEC) and Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, ● Fed. Reg. ● (proposed ●, 2012) (CFTC). We refer to both the joint notice of proposed rulemaking, 76 Fed. Reg. 68846 (proposed Nov. 7, 2011) and the CFTC notice of proposed rulemaking as the “Proposed Rule,” but we cite to pages of the Federal Register version of the joint notice of proposed rulemaking (the “NPR”). We also refer to the text of the proposed common rules (including the appendixes) as the “Proposed Rule,” the text preceding the proposed common rules as the “Preamble” and the appendixes of the Proposed Rule as the “Appendixes.”

² The Volcker Rule is codified as Section 13 of the Bank Holding Company Act of 1956, as amended (the “BHC Act”).

³ A table of contents is provided in Annex A. This letter is not intended as a comprehensive response to all of the Agencies’ requests for comments on the proprietary trading prohibition.

different asset classes and markets, which avoids the many inevitable drawbacks of a “one size fits all” approach.

Yet metrics receive too little emphasis in the Proposed Rule. The remainder of the criteria for permitted activities, which are generally qualitative, often appear inappropriately restrictive and in many cases are not flexible enough to work effectively across a range of markets and asset classes. Commentary throughout the Proposed Rule also creates many negative presumptions (that is, circumstances in which trading will be presumed to be prohibited proprietary trading). Within this framework, the usefulness of quantitative trading metrics would be severely limited. Accordingly, our key recommendation is that the Proposed Rule be substantially altered to refocus on the application of quantitative trading metrics in a flexible manner, simplify other criteria for permitted activities and remove negative presumptions and other commentary that we identify in this letter.⁴

Without substantial revisions, the Proposed Rule will define permitted market making-related, underwriting and hedging activities so narrowly that it will significantly limit our ability to help our clients—businesses and investors in the United States and around the world—raise capital, manage their risks, invest their wealth and generate liquidity from their holdings. As one of several major U.S.-based, internationally active dealers in securities, commodities and derivatives, a primary dealer of sovereign debt in 18 countries (including the United States) and a provider of investment banking and other capital-raising services around the world, we think that the final rule must be modified in order to avoid this unintended and unfortunate outcome.

Our hope is that, as some have already suggested, Volcker Rule compliance will be an iterative process that the Agencies will approach with open minds over the multi-year conformance period.⁵ This will prove to be difficult unless the final rule is a more neutral and adaptable construct without negative presumptions or undue restrictions on permitted activities. In this letter, we offer suggestions that we believe can accomplish this goal and specific recommendations that we hope will be helpful to the Agencies as they draft the final rule.

⁴ We also note that the Preamble to the Proposed Rule appears to describe the quantitative trading metrics as supplemental to the text of the Proposed Rule itself (e.g., NPR at 68882-83). The final rule should state clearly that the quantitative trading metrics, guided by the principles articulated in the final rule, will be used to evaluate compliance with the requirements of the statute.

⁵ For example, at the January 18, 2012 hearing of the House of Representatives on the Volcker Rule, Governor Tarullo said: “[T]he proposed rule, as you can tell, is informed by an expectation that there’s going to be an iterative quality to its implementation.” *Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation: Hearing before the Subcomm. on Capital Markets and Government Sponsored Enterprises and the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 112th Cong. (2012) (statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

This Introduction discusses the following topics:

- the statutory requirements for market making-related, underwriting and hedging activities, as well as the recommendation of the Financial Stability Oversight Council (the “FSOC”), in its study of the Volcker Rule,⁶ of a quantitative metrics-based approach to evaluate such activities that would be developed over time and through experience;
- the Proposed Rule’s approach and the key problems that are likely to arise from language that is too narrowly crafted to allow important permitted activities;
- the most critical issues in the Proposed Rule that are likely to harm both markets and banking entities’ customers; and
- the need for a multi-phase implementation of the proprietary trading prohibition of the Volcker Rule to minimize unintended disruptions to markets and unnecessary costs.

We provide a high level overview of each of these issues before we discuss specific problems with the Proposed Rule in greater detail in the body of this letter.

The Statutory Requirements and the FSOC’s Recommended Approach

The main challenge of the Volcker Rule’s prohibition on proprietary trading is *not* a result of the fundamental requirement of the statute: that banking entities eliminate their standalone proprietary trading businesses. Chairman Volcker and Congress clearly intended to prohibit these “walled-off” or “bright-line” proprietary trading businesses,⁷ and we, along with many of our peers, have already exited these businesses.⁸ The real problem with the Proposed Rule is that it fails to properly and effectively exempt from its strictures those activities that Congress clearly intended *to allow*, and that the FSOC Study acknowledged as vital for effective markets.⁹ These include market making-related, underwriting and risk-mitigating hedging activities.

The statutory exemptions for these permitted activities are conceptually straightforward: market making-related and underwriting activities are permitted provided that they “are *designed* not to exceed the

⁶ FSOC, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds 36-43 (Jan. 2011) (the “FSOC Study”).

⁷ Chairman Volcker appeared to have “bright-line” proprietary trading businesses (generally readily identifiable units with dedicated trading capital) in mind when he stated, “[E]very banker I speak with knows very well what ‘proprietary trading’ means and implies. . . . [Banking entities] have sometimes explicitly labeled a trading affiliate or division as ‘proprietary’, with the connotation that the activity is, or should be, insulated from customer relations.” *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. (2010) (written statement of Paul A. Volcker, Chairman, President’s Econ. Recovery Advisory Bd.).

⁸ We have already exited certain trading businesses that are inconsistent with the limits on proprietary risk-taking in the Volcker Rule. In 2010 and 2011, we liquidated substantially all of the positions in our Principal Strategies business in our Equities business unit and our former global macro proprietary trading business.

⁹ FSOC Study at 1, 16.

reasonably expected near term demands of clients, customers, or counterparties,”¹⁰ and hedging activities are permitted provided that they are “*designed to reduce*. . . specific risks” that are “in connection with and *related to*” individual or aggregated positions, contracts, or other holdings.¹¹

The statutory language does not define these permitted activities narrowly, impose negative presumptions or require after-the-fact analysis potentially down to the level of a single trade—but the Proposed Rule does. With respect to risk-mitigating hedging, the statutory language does not provide detailed prescriptions as to how risk must be reduced—but the Proposed Rule does. The FSOC Study considered the varied nature of financial intermediation services and hedging in markets as diverse as equities, fixed income, commodities, interest rates and foreign exchange, among others, and the need to account for that variation in the implementing regulations—but the Proposed Rule does not.¹²

It can be difficult in practice to distinguish permitted activities from prohibited ones when dealing with a wide array of markets, market practices and clients, customers and counterparties of banking entities.¹³ To help draw this distinction, the FSOC Study proposed using quantitative trading metrics.¹⁴ Under the FSOC’s recommended approach, these metrics would not be subject to pre-set fixed limits, but would instead provide indicative and contextual data that would enable regulators to develop a view, which could evolve over time, as to whether a banking entity’s trading activities in a given asset class or market were consistent with the prohibition on proprietary trading.¹⁵ If a particular business’s metrics fell outside of thresholds established by banking entities and reviewed by their regulators, regulators would examine the activity in question in more detail and evaluate whether its design was consistent with the permitted activities exemption or should be modified to conform to the statutory requirements.¹⁶

¹⁰ Section 13(d)(1)(B) of the BHC Act (emphases added).

¹¹ Section 13(d)(1)(C) of the BHC Act (emphases added). In view of this clear statutory language, it would appear that, if any presumptions are to apply, market making-related, underwriting and hedging activities should be presumptively permissible. In contrast, under the Proposed Rule, they would often be presumptively prohibited.

¹² *E.g.*, FSOC Study at 18-19, 22-23, 26-27.

¹³ The Preamble to the Proposed Rule notes that market making in particular cannot be defined in a uniform way that will hold true across varied asset classes and markets. *E.g.*, NPR at 68871 (“The Agencies. . . recognize that [indicia of market making-related activities] cannot be applied at all times and under all circumstances because some may be inapplicable to the specific asset class or market in which the market making activity is conducted.”). As we explain in this letter, however, we are concerned that the Proposed Rule itself does not adequately reflect this understanding.

¹⁴ FSOC Study at 36-37.

¹⁵ *Id.* at 37 (“[M]etrics are best utilized by Agencies as a key source of information for identifying potentially problematic trading activities that may require further study, rather than a comprehensive, dispositive tool. In addition, the relevance or utility of any particular metric may vary significantly depending on the asset class, liquidity, trading strategy and market profile of the trading activity in question.”). For example, a market maker may engage in more inter-dealer trading (as indicated by customer-facing activity metrics) and may retain more principal risk (as indicated by risk metrics such as Value at Risk (“VaR”)) in a less liquid market or for larger-sized transactions than in a more liquid market or for smaller-sized transactions, but this may not necessarily be indicative of proprietary trading.

¹⁶ We emphasize that our approach does not assume that a banking entity’s current activities should be a permissible “baseline” for the quantitative trading metrics. Instead, we intend for our approach to provide regulators
(*footnote continued*)

We believe that this metrics-based approach remains the right one, but only if it is utilized in the flexible way that the FSOC Study envisioned. A metrics-based approach is unlikely to produce many “bright lines” initially, and both the design and implementation will require robust and ongoing dialogue between banking entities and their regulators. This is inevitable because determinations under the Volcker Rule will require the application of judgment to fact-specific situations. It is also desirable, because neither regulators nor banking entities can predict today all of the challenges that will arise in implementing the Volcker Rule, or how markets will evolve in the future. A metrics-based approach is consistent with the FSOC Study’s recommendation that “[t]he Volcker Rule. . . be implemented with the understanding that markets, products and trading activity will continue to evolve. Agencies’ supervisory approaches should be flexible enough to account for this evolution.”¹⁷

Key Problems with the Proposed Rule’s Approach

The Proposed Rule undercuts the statutory language and the FSOC Study by taking a narrow view of market making-related, underwriting and hedging activities. This view appears to be based largely on the model of highly liquid and exchange-traded U.S. equity markets and appears to assume that market makers play an agency role, matching buyers and sellers without, in many cases, assuming much principal risk.¹⁸ This model seems to underlie the Proposed Rule’s restrictions on banking entities’ ability to hold inventory and to hedge, as well as the requirement that a market maker’s revenues must be designed to come “primarily” from fees, commissions and spreads.¹⁹

But markets such as interest rates, credit, commodities, and foreign exchange, and even many equities markets (including emerging markets and block trading in equities generally), operate differently from those for U.S. equities traded on exchanges in smaller than “block” sizes. These markets are generally less liquid, much of the trading is done over-the-counter (“OTC”), “on screen” prices are often unavailable, buyers and sellers often cannot be matched promptly (much less instantaneously) or in positions of the same size, inter-dealer trading is necessary for price discovery and risks often cannot be “perfectly” hedged.

The Proposed Rule’s rigid application of an agency-based, exchange-traded equities paradigm threatens to reduce liquidity in these markets. Generally, liquidity can be thought of as a spectrum reflecting the degree to which an asset can be converted to cash (or cash equivalents) reasonably quickly, with as small a discount as possible to the price that might have been obtainable over a longer time horizon, and without causing large price movements. When an asset is illiquid, trading is more costly, and fees or

(footnote continued)

with needed flexibility to develop views on threshold levels of quantitative trading metrics that should represent permissible activities for different markets and asset classes. These metrics will need to be viewed holistically, and no one metric should be determinative of whether a particular trading unit’s activities will be considered prohibited proprietary trading.

¹⁷ *Id.* at 26.

¹⁸ As we discuss in more detail in this Introduction and in Section I.A, this view is often inaccurate even when applied to exchange-traded equities, particularly for large block trades, illiquid small-capitalization issuances and emerging markets. It also imports requirements that are properly applicable only to exchange-registered “specialist” market makers, which represent only a small subset of all market makers and generally trade in smaller than “block” sizes.

¹⁹ Section __.4(b)(2)(v) of the Proposed Rule.

spreads are higher. Even more fundamentally, because liquidity is inherently valuable, illiquidity also generally reduces fair values, outside the context of any particular trade. Liquidity is especially critical in periods of market dislocation. Without it, volatility can increase substantially.

Market makers are essential providers of liquidity, buying or selling when markets are imbalanced and building and holding inventory to meet future customer demand.²⁰ In fact, in many markets, market makers provide the vast majority of the liquidity, and can be the only providers of liquidity in times of stress, when other market participants may withdraw.²¹

Reducing liquidity will have tangible costs for companies and investors alike and will pose obstacles to the free flow of capital and efficient allocation of resources throughout the United States and global economies. A recent study by Oliver Wyman estimated the potential effects of the Volcker Rule on the \$7 trillion corporate credit market that is vital to the U.S. economy. In this market alone, Oliver Wyman estimates that an overly restrictive application of the Volcker Rule could cost investors as much as \$90 billion to \$315 billion in mark-to-market losses on their existing holdings, and \$1 billion to \$4 billion in higher annual transaction costs.²² The same study also estimated that issuers of U.S. corporate bonds could face \$12 billion to \$43 billion in higher annual borrowing costs to compensate investors for lower liquidity.²³ This is capital that could otherwise go to investment and job creation, or be returned to shareholders.

Although one of the key aims of Dodd-Frank was to promote greater stability in financial markets, we are concerned that the Proposed Rule could inadvertently increase systemic risk rather than reduce it. Even in more stable markets, the Proposed Rule may push trading activity offshore or to less well-regulated sectors, leaving regulators with a less comprehensive view of market risks and a reduced ability to anticipate and address periods of market stress.²⁴

²⁰ Providing liquidity is at the heart of market making. See, e.g., the comment letter on the proprietary trading prohibition of the Volcker Rule submitted by AllianceBernstein L.P. on November 16, 2011, p. 2 (“Market making is a core function of banking entities and provides liquidity needed by all market participants, including the pension funds, endowments and individual investors that are [AllianceBernstein’s] investment management clients. We believe it is crucial that the steps mandated by the Dodd-Frank Act be implemented in a manner that does not disrupt the liquidity necessary for functioning securities markets and impose potentially prohibitive costs and burdens on market participants.”).

²¹ The National Association of Securities Professionals (“NASP”) has noted that “[b]roker-dealers—both large and small—are obligated to act as agent for buyers and sellers by executing their orders in the market, or act as a principal by supplying liquidity directly to clients. This role is particularly vital to US interests on a routine basis and even more so in times of crisis when natural buyers may be hard to find.” Comment letter on the proprietary trading prohibitions of the Volcker Rule submitted by NASP on December 21, 2011, p. 1.

²² Oliver Wyman, *The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity 4* (Feb. 2012).

²³ *Id.*

²⁴ Oliver Wyman provided the following analysis of the consequences of pushing trading activity to entities not subject to the Volcker Rule: “[T]he natural question arises of whether new or existing firms not subject to Volcker would take the place of today’s bank-affiliated market makers. The answer is a complex and qualified *eventually*. . . . In some asset classes, hedge funds and other active traders can and do provide incidental liquidity as they pursue trading strategies. However, such firms do not have a business model based on making markets,
(footnote continued)

In addition to providing liquidity, market makers play a critical role in helping clients to reduce and hedge risk, often by assuming risk on their behalf. This is true in all markets, not just the smaller and less liquid ones. Because of economies of scale, risk diversification and broad experience in risk management, market makers can often manage risk more effectively and less expensively than their customers can on their own. But to do so, market makers need to act as principals by committing capital, and then to hedge effectively, whether dynamically, on a portfolio basis or across asset classes (or using a combination of these strategies), and whether by trading directly with customers or with other dealers. All of these activities could raise red flags under the Proposed Rule's narrow definition of permitted hedging and its presumptions against inter-dealer trading.

If the constraints of the Proposed Rule make hedging prohibitively expensive (or even prohibit it entirely), banking entities' clients and customers will be forced to hold more risk on their own books. This will increase the volatility of their earnings and hurt their share prices, which in turn will raise their cost of capital, reduce their capacity to invest, lower their returns to shareholders and diminish their appeal as strategic partners.

To illustrate the problems with the construction of the Proposed Rule and what is at stake, we offer two "real-world" examples. Both highlight the key point that, to facilitate customer transactions effectively, market makers often must commit capital, hold positions in inventory and be exposed to price movements of the inventory while they do so. Any uncertainty about the permissibility of these activities under the Proposed Rule will threaten the range of services that market makers could otherwise provide to their clients and customers. Furthermore, while market makers typically hedge their exposures to price movements of inventories, if the Proposed Rule is adopted as drafted, they may not always be able to do so economically and in a manner that satisfies the Proposed Rule's restrictions on permitted hedging.

First, consider a U.S. company that issues bonds to finance its expansion plans. A banking entity facilitates the bond issuance in two ways. As an underwriter, it purchases the bonds directly from the company and redistributes them to the broader market. This underwriting activity is clearly covered by the statutory exemption. However, this is not the end of the banking entity's involvement. The banking entity will typically also engage in critical market making-related activities in connection with the underwriting, the treatment of which is less clear under the Proposed Rule. As a market maker, the banking entity may help deepen the market for the bonds by buying back the company's outstanding debt. This is necessary when investors prefer to buy the issuer's new (and more liquid) bonds but may need to exchange the issuer's older (and less liquid) bonds to free up capacity in their portfolios or to meet their own investment mandates.

The banking entity provides this liquidity by buying the older bonds, even if it may not anticipate being able to resell them quickly. To resell the older bonds quickly, the banking entity would have to offer a significant price concession (discount), but by making the issuer's credit available at lower prices, this would reduce the price of the new bonds. To avoid this result, the banking entity may hold the older bonds in inventory until it is able to resell them under more favorable conditions. It will need to hedge this position,

(footnote continued)

and are at best opportunistic sources of liquidity. . . . Many funds withdraw from the markets in times of trading stress. . . . [Furthermore, p]ushing the critical and complex activity of market making outside of the most carefully regulated financial institutions is both inconsistent with the statute and a poor policy outcome." *Id.* at 18 (emphasis in original).

and may seek to hedge on a portfolio basis or with instruments that might not perfectly hedge the exposure. By broadening the market for the new bonds, the banking entity helps the company raise capital at a better price—which is, of course, the goal of underwriting.

If the Proposed Rule is adopted as drafted, the banking entity may be unable or unwilling to repurchase the company's outstanding debt because it is uncertain as to whether it can hold the older bonds in inventory, whether it can generate revenues from changes in the price of the bonds while they are held in inventory or whether it can properly hedge its resulting risk. As a result, the company may raise less capital because fewer investors may be willing to buy the new bonds without reselling the older ones. Furthermore, because the new bonds would be issued in a less liquid market with wider bid-offer spreads, they may actually be less valuable than they would have been before the Volcker Rule. To compensate for this illiquidity cost, investors will likely demand higher yields, raising the issuer's cost of capital.²⁵

Second, consider a U.S. pension fund that decides to sell a large stake in a company's stock to fund its near-term pension obligations. To sell a large stake without significantly depressing the market price or signaling its intentions to the broader market, the pension fund will turn to a market maker to execute a large (or "block") trade. The market maker will buy the entire position from the pension fund, at a discount to the market price, and resell it to the broader market. Depending on the prevailing market conditions, to avoid price dislocation, the market maker may need to hold a portion of the block on its own books and gradually resell the remaining stake.

As in the first example, if the Proposed Rule casts doubt on the market maker's ability to resell the stake over time, restricts the market maker from generating revenues from price movements (even unintentionally) or limits the availability of permissible hedges, then the market maker will need to minimize its inventory and, as a result, will likely charge the pension fund a higher discount so that it can quickly resell the stake at what may be reduced prices.²⁶ Higher discounts would erode savings, raise costs for employers and reduce pension security for the fund's participants, and could drive pension funds to raise their risk profiles to meet their funding needs.

These two examples—and many more are given in this letter—suggest that the Proposed Rule should be substantially reworked to ensure that the Volcker Rule does not unintentionally harm U.S. businesses, U.S. investors and their global counterparts, and U.S. banking entities. The negative

²⁵ In connection with the January 18, 2012 hearing of the House of Representatives on the Volcker Rule, Alexander Marx, the Head of Global Bond Trading at Fidelity Investments, also noted this real-world effect of decreased market liquidity, stating that "[t]here are at least three negative outcomes arising from this reduced liquidity: [b]usiness growth and activity will be hampered as a result of companies and municipalities having less efficient access to capital, with resulting deleterious effects on employment and the economy. Security transactions will be more challenging to carry out and there will be negative effects on the investment performance of the funds that individual investors, pension plans, and other institutional investors hold. A less predictable flow of purchases and sales of securities, caused by the foregoing factors, will result in price uncertainty and higher volatility, which would ultimately damage issuers and investors alike." *Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation: Hearing before the Subcomm. on Capital Markets and Government Sponsored Enterprises and the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 112th Cong. (2012) (written statement of Alexander Marx).

²⁶ As we discuss in more detail in Section I.A.5, while the Proposed Rule offers a block trade exemption, it may be too narrow, and it is unclear how the revenue generation requirement would operate in this context.

consequences could be far-ranging, with the Volcker Rule putting U.S. banking entities at a severe competitive disadvantage to their non-U.S. counterparts, imposing substantial costs (which do not appear to have been sufficiently analyzed²⁷) and hindering many traditional financial activities that create no meaningful risk for banking entities, other financial services firms or countless industrial and other nonfinancial companies. Trading in the sovereign debt of non-U.S. governments is also likely to be hindered, as several non-U.S. financial authorities have recently stated,²⁸ to the detriment of the global economy and the safety and soundness of the U.S. financial system.

We endorse the goal of strengthening the safety and soundness of the U.S. financial system, and we understand that Congress has mandated a change in our business. We are not arguing that the line between permitted activities and prohibited proprietary trading be drawn in such a way as to permit all activities in which we have historically engaged. Yet we do not believe that Congress intended Dodd-Frank to cause any of the negative consequences described above. Indeed, Dodd-Frank mandates that the Agencies' coordinated rulemaking "avoid providing advantages or imposing disadvantages to the companies affected by [the Volcker Rule] and. . . protect the safety and soundness of banking entities and nonbank financial companies supervised by the [Federal Reserve]."²⁹

The Most Critical Issues with the Proposed Rule's Definitions of Permitted Activities

As we noted above, notwithstanding the conceptual clarity of the statute's permitted activities (and the FSOC Study's endorsement of an approach that preserves that conceptual clarity), the Proposed Rule goes in a different direction. It includes extensive qualitative descriptions of what will constitute permitted market making-related, underwriting and hedging activities. It relies heavily on the paradigm of highly liquid and exchange-traded U.S. equity markets. And it establishes negative presumptions that may be difficult to rebut.³⁰ This approach is not required by the statutory language of the Volcker Rule, is contrary to the recommendations of the FSOC Study, and is otherwise inappropriate in several key respects:

²⁷ The absence of a cost-benefit analysis of the Proposed Rule is discussed in detail in the comment letter on the proprietary trading prohibition of the Volcker Rule submitted by the Securities Industry and Financial Markets Association, The Clearing House, The Financial Services Roundtable and the American Bankers Association. We support the analysis in that letter and the concerns expressed about the level of costs imposed by the Proposed Rule.

²⁸ We discuss some of the comments already submitted by non-U.S. financial authorities on this topic in Section I.A.5.

²⁹ Section 13(b)(2)(B)(ii) of the BHC Act.

³⁰ The FSOC Study and the Proposed Rule both cite SEC guidance on indicia of market making in U.S. equity markets (guidance that, itself, is more indicative of "specialist" market making than of most types of market making), and these indicia factor heavily in the Proposed Rule. *E.g.*, FSOC Study at 28-29; NPR at 68870-71, n.148. As part of the same discussions in the respective documents, however, the FSOC Study and the Proposed Rule both acknowledge that these indicia may be different in other markets, particularly less liquid ones. We are concerned that this acknowledgment could ultimately be of limited use under the Proposed Rule because the Proposed Rule effectively requires a banking entity (and its regulator) to try to analogize each trading activity to U.S. equities, which is often a strained and inapposite comparison, rather than directly evaluate the trading activity under the statutory language of the Volcker Rule. We discuss this issue in more detail in the body of this letter.

- **Inter-dealer trading:** Appendix B of the Proposed Rule provides that “market makers. . . typically only engage in transactions with non-customers to the extent that these transactions *directly* facilitate or support customer transactions.”³¹ This statement, and the severe limits on inter-dealer trading that result from it, are inconsistent with the statute, which refers equally to “counterparties” as it does to “customers and clients.” Even more importantly, the statement is factually inaccurate when applied to many markets and could severely limit key elements of market making that depend on inter-dealer trading.

The FSOC Study acknowledged the role of trading in price discovery and market making as “an important and necessary part of managing the risk exposure of a market maker.”³² In many cases, participation in inter-dealer markets is necessary to provide accurate prices to customers and is an indispensable source of hedging transactions for market makers seeking to mitigate risks arising from customer transactions. Inter-dealer markets also allow customers to access a larger pool of liquidity than any single dealer could provide. The range of customer transactions that a market maker would realistically be able to facilitate would be severely constrained if it could not price, exit or hedge positions through inter-dealer trading.

- **“Regular or continuous” willingness to buy or sell and provide price quotes:** The Proposed Rule requires that a market maker “hold itself out as being willing to buy and sell” an instrument in which it makes a market “on a regular or continuous basis,” and seems to suggest that this requirement is to be met primarily by regularly providing price quotes (in more liquid markets, “continuous[ly]” making “broadly disseminated” two-sided quotes).³³ These activities are characteristic of some U.S. equity market making in some circumstances (for example, trading of certain U.S. equity securities in smaller than “block” sizes), but do not generally apply to portions of the U.S. equity markets, other less liquid markets or markets, such as fixed income markets, in which demand is distributed over a much larger number of instruments, many of which are rarely traded and are therefore rarely priced.

Furthermore, the Proposed Rule’s suggestion that market makers should be registered to trade on exchanges and its description of market making-related activities as being generally “passive”³⁴ do not reflect the role that market makers play in bridging supply and demand across fragmented markets and trading platforms by engaging in “active” trading and using a range of order types to manage inventory and test the depth of markets.

- **Inventory management and primary dealer requirements:** The Preamble to the Proposed Rule suggests that trading by a market maker in anticipation of customer trades must be “related to clear, demonstrable trading interest of clients, customers, or counterparties,”³⁵ which would go far beyond the statutory requirement that such trading be “*designed* not to exceed the *reasonably expected* near term demands of clients, customers, or counterparties.” Indeed, this interpretation

³¹ NPR at 68961 (emphasis added).

³² FSOC Study at 24.

³³ NPR at 68870-71.

³⁴ *E.g., id.* at 68960.

³⁵ *Id.* at 68871.

would be contrary to the statutory language, since “clear [and] demonstrable” and “reasonably expected” are essentially mutually exclusive. The statutory test implies something that can be reasonably, but not definitively, anticipated in advance through experience and inferences based on market conditions, that has, by definition, not yet risen to the level of “clear [and] demonstrable.” The statutory language would have no meaning if all customer trading interest needs to be “clear [and] demonstrable.”

Furthermore, the statutory language suggests that regulators should focus on how trading activities are *designed* to meet the reasonably expected near term demands of clients, customers or counterparties over time, not how those demands have actually manifested themselves at any given point in time. If market makers do not have discretion to accumulate and manage inventory without a direct relationship to a specific customer trade, their ability to provide liquidity and maintain an orderly market will be greatly limited. Customers’, clients’ and counterparties’ transaction costs will rise, and the value of their investment holdings will fall, especially in periods of market stress.³⁶

Finally, the exemption for market making-related and underwriting activities may not always be sufficient to permit banking entities to satisfy their obligations as primary dealers of sovereign debt in non-U.S. jurisdictions, where they may, for example, be required to purchase allotments even if they cannot be resold to customers in the near term.

- **Sources of market making-related revenues:** The Proposed Rule requires that permitted market making-related activities be designed to generate revenue “primarily from fees, commissions, bid/ask spreads” and other sources not attributable to price movements of positions in inventory or hedging.³⁷ Once again, the Proposed Rule appears to presuppose a highly liquid market in which market making-related activity is close to agency trading. This is problematic because most markets are fragmented and illiquid and require market makers to take and retain principal risk. For example, in its study of the credit default swap (“CDS”) market, the Federal Reserve Bank of New York (the “FRBNY”) found that “the combination of low and variable trading frequency with large and homogenous notional trade sizes. . . seems to highlight the importance of market makers, who are willing to take on a position in a rarely traded asset and hold the risk for some time.”³⁸ In markets such as this, revenues will not always come

³⁶ Maintaining inventory is critical to making a market in a number of instruments. In the case of corporate credit instruments or structured credit instruments (which cannot be sold short), market makers must hold inventory to accommodate sales to customers. Even in equities, market making-related activity involves accumulating and managing inventory to meet expected customer demands and to keep orderly markets. Maintaining inventory also helps to speed trade execution for customers, reduce volatility and improve pricing.

As we discuss in more detail in Sections I.A.5 and I.A.6, market makers must also have discretion to *dispose* of inventory in a manner that allows them to provide the best prices to customers without unnecessarily increasing volatility or otherwise disrupting the market. However, the Proposed Rule would constrain this necessary discretion by creating uncertainty about a banking entity’s ability to hold inventory and the treatment of revenues from price movements of that inventory.

³⁷ Section __.4(b)(2)(v) of the Proposed Rule.

³⁸ Kathryn Chen et al., *An Analysis of CDS Transactions: Implications for Public Reporting*, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 517, Sept. 2011, at 10.

“primarily” from customers.³⁹ A revenue test based on a “primarily” standard will likely also be unworkable in more volatile markets such as commodities, where revenues from price movements may be significant, even when positions are held for relatively short periods of time.

- **Dealer registration requirements:** To rely on the exemption for market making-related activities, the Proposed Rule requires that a banking entity be an SEC- or CFTC-registered dealer (or exempt from such registration) or be engaged in the business of a dealer in a non-U.S. jurisdiction and subject to substantive local regulation.⁴⁰ Effective market making often requires that a banking entity trade on several exchanges and platforms and in a variety of markets, including ones in which the banking entity trades through legal entities other than SEC- or CFTC-registered dealer entities. Furthermore, many non-U.S. markets simply do not provide substantive regulation of dealers for all asset classes. Consequently, the Proposed Rule may prevent banking entities from participating in those markets.
- **Underwriting and market-stabilizing practices by underwriters:** Although the Preamble to the Proposed Rule states that the underwriting exemption is intended to cover private placements⁴¹ and to “permit underwriters to continue to employ existing practices to stabilize a distribution of securities,”⁴² the Proposed Rule itself uses technical SEC terms and other language that, in our experience, are not broad enough to give effect to this intention. Furthermore, the requirement that permitted underwriting-related activities be “solely” in connection with an underwriting is not only inconsistent with the statute, but may also create uncertainty about many underwriting-*related* activities that are integral to underwritings and beneficial for capital raises.
- **Permitted hedging strategies:** Whereas the statute requires that permitted hedging activities be “*designed to reduce. . . specific risks,*” the Proposed Rule goes further by requiring that hedging positions be “reasonably correlated” to the respective underlying positions and not introduce any new “significant exposures.”⁴³ These conditions could unduly restrict a great number of effective hedging strategies, including portfolio hedging and “scenario” hedging of macroeconomic risks, which can legitimately and effectively reduce specific risks. As a result, the Proposed Rule could actually decrease safety and soundness by reducing effective risk management options.

As we will explain in more detail, these concerns can be resolved in the final rule without creating loopholes for prohibited proprietary trading. For example, to evaluate the amount of inter-dealer trading that is consistent with market making-related or hedging activity in a particular trading business, customer-facing activity metrics will be more effective than the Proposed Rule’s negative presumptions

³⁹ Consistent with our view that metrics represent the best path forward, we believe that customer revenues themselves, as measured by Spread P&L or other metrics, are a useful reference point, especially because a proprietary trading desk would generally not be expected to earn *any* revenues this way. However, the “primarily” standard remains problematic.

⁴⁰ Section __.4(b)(2)(iv) of the Proposed Rule.

⁴¹ NPR at 68867.

⁴² *Id.* at 68925.

⁴³ Sections __.5(b)(2)(iii)-(iv) of the Proposed Rule.

against inter-dealer trading and will avoid the adverse consequences to liquidity that would accompany those negative presumptions.⁴⁴

For the metrics-based approach to be effective, however, the final rule will also need to provide a less granular definition of “trading unit,” acknowledging that it will be appropriate in many cases for the smallest trading unit to be larger than what the Proposed Rule refers to as a single trading desk. Although calculating quantitative trading metrics over a banking entity’s entire trading business could conceivably “mask” prohibited proprietary trading, we believe that it will be possible to measure metrics at reasonable intermediate levels, and over reasonable time periods, in a way that will allay this concern while mitigating extreme operational expenses and burdens and unreliable results—all of which would accompany any trade-by-trade analysis of permitted market making-related or other activities.⁴⁵ Effective and appropriate use of metrics will also avoid creating adverse effects on traders’ effective market making, which could further reduce liquidity and raise costs to customers.

Timeline and Process for Implementation and Other Topics

Because the Volcker Rule applies to a range of highly complex and variable trading operations, it will take substantial time for the Agencies to develop a full understanding of how to apply its requirements to different asset classes and markets. It will also take time for banking entities to build the necessary compliance infrastructure. In view of this, as well as the delayed timing of the final rule, we recommend that the Federal Reserve’s conformance rule be revised with respect to the proprietary trading prohibition of the Volcker Rule to implement the full requirements of the final rule in multiple stages.⁴⁶ In this framework, “bright-line” proprietary trading would cease, and a compliance and metrics reporting regime would be developed, not by July 2012 but over the conformance period and, in the case of the compliance program, potentially the following years as well. Additionally, definitive rules could become effective over time on an

⁴⁴ We provide additional comments on how quantitative trading metrics should be used (and suggestions for improvements to those metrics) in Section II.C. For example, the Customer-Facing Trade Ratio in the Proposed Rule places an undue emphasis on the *number* of transactions with customers versus other “counterparties,” which does not reflect the *size* of transactions or the amount of risk that market makers undertake for customers. We would instead define the ratio so that it measures the notional principal or risk associated with customer transactions and is appropriately tailored to the relevant asset class or market.

⁴⁵ Specifically, the level at which a trading unit’s quantitative trading metrics are measured should be consistent with the level at which a banking entity calculates VaR and other risk limits, determines trading book size, budgets profit and loss, assesses capital usage, analyzes compensation metrics (under guidance from its regulators) and operates its existing risk management processes. Such levels typically reflect customer bases, the levels at which there is clear trading management accountability and authority to direct actions and the levels at which banking entities engage with their prudential regulators on safety and soundness risk metrics.

⁴⁶ The Federal Reserve issued a final rule on the Volcker Rule conformance period in February 2011, which provided banking entities with two years from the effective date of the Volcker Rule to bring their existing proprietary trading activities into compliance. Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (finalized Feb. 14, 2011). In Question No. 347 of the Proposed Rule, the Agencies request comment on whether this conformance rule should be revisited. Given the extraordinary complexity involved in developing rules on proprietary trading that accomplish Congress’s objectives without serious adverse consequences, we believe the conformance period should be implemented as we discuss in this letter.

asset-class-by-asset-class basis.⁴⁷ This multi-phase approach would mitigate both the market and customer disruptions and the logistical problems associated with a rush to attempt full compliance before the application of the final rule is well understood (or even known).⁴⁸

In our more detailed discussion of the issues that have the potential to harm markets, raise U.S. companies' cost of capital and erode U.S. investors' savings, we make recommendations, including additional suggestions on permitted trading activities and the implementation and ongoing supervision of a Volcker Rule compliance regime.

I. DETERMINING PERMITTED MARKET MAKING-RELATED, UNDERWRITING AND HEDGING ACTIVITIES

A. Permitted Market Making-Related Activities

The Proposed Rule articulates both express requirements for permitted market making-related activities and statements about the nature of market making that suggest how the Agencies may interpret the requirements of the rule itself. While we appreciate that the Proposed Rule sometimes acknowledges that the necessity of risk retention varies across markets,⁴⁹ it nonetheless relies heavily on the comparatively simple case of market making in 100-share (round) lots of highly liquid and exchange-traded U.S. equities. This agency-based model threatens to overshadow the true nature of market making. In large part, market makers' most essential function is to provide liquidity when trades *cannot* be completed on an agency-like basis (or something close to it).⁵⁰ This is often the case, especially though not exclusively in less liquid markets.⁵¹

⁴⁷ As a successful example of gradual and deliberate implementation, we point to the trade reporting and compliance engine ("TRACE") for fixed income trades, which followed this model. We discuss this example in more detail in Section III.A.

⁴⁸ We suggest that, in view of the challenges of designing an effective final rule and the critical importance of market making-related, underwriting and hedging activities to U.S. businesses and U.S. investors, the Agencies consider re-proposing the Volcker Rule regulations.

⁴⁹ *E.g.*, NPR at 68960 ("The size and type of risk that must be retained [to provide effective intermediation services] may vary widely depending on the type and size of the positions, the liquidity of the specific market, and the market's structure. As the liquidity of positions increases, the frequency with which a market maker must take or retain risk in order to make a market in those positions generally decreases.").

⁵⁰ This point is well established in many foundational analyses of market making. *E.g.*, Sanford J. Grossman & Merton H. Miller, *Liquidity and Market Structure*, 43 J. FIN. 617, 618-19 (1988). *See also* Darrell Duffie, *Market Making Under the Proposed Volcker Rule*, Jan. 2012, at 7, 12 ("The service that [a market maker] provides is 'immediacy,' the ability to immediately absorb a client's demand or supply of an asset into its own inventory. . . . If market makers were to refrain from absorbing supply and demand imbalances into their inventory in anticipation of likely price improvements, the price impacts suffered by those seeking immediacy would be deeper, and the corresponding distortions in prices would be larger and more persistent.").

⁵¹ In many fixed income markets, for example, if a customer wishes to sell a portfolio of positions, it may solicit "bids wanted in competition" ("BWIC") from a group of market making dealers. The dealer bids are usually due at a specified time, and the dealers use the allotted time to attempt to obtain bids for the portfolio from other customers. These attempts are rarely successful in obtaining bids for the entire portfolio (at any price) in the time allotted. In other words, even under the current regulatory regime, it is common practice for dealers to attempt and fail to trade
(footnote continued)

Principal trading is critical for market making even in more liquid markets. It is, in fact, mandatory for registered market makers on exchanges such as the New York Stock Exchange (the “NYSE”) and the Chicago Board Options Exchange (the “CBOE”). Although these U.S. exchange-based registered market makers may sometimes trade on what is relatively closer to an agency basis, they are nonetheless also expressly required to take on principal risk as necessary to maintain an orderly market.⁵² As we explain in more detail below, this is generally true of primary dealers of a government’s sovereign debt as well.

We acknowledge that, to be successful, a Volcker Rule compliance regime will need to distinguish between principal risk taken in a legitimately market making-related (or underwriting) capacity and prohibited proprietary trading. We agree with the Agencies that quantitative trading metrics can be “calibrated” to reflect the differences among asset classes and markets. But the Proposed Rule’s many negative presumptions and other qualitative requirements threaten to significantly hinder an effective calibration process. The following are the key presumptions and statements suggesting how the Agencies intend to implement the Proposed Rule that we believe are too restrictive, are not fully accurate as characterizations of market making-related activity or would be inappropriate when applied to a range of markets and asset classes.⁵³

- “[M]arket makers. . . typically only engage in transactions with non-customers to the extent that these transactions directly facilitate or support customer transactions.”⁵⁴
- Trading that “is not in response to, or driven by, customer demands” would not be permissible under the market making exemption, “regardless of whether those activities promote price transparency or liquidity.”⁵⁵

(footnote continued)

on an agency-like basis first, before taking principal risk. Disposing of only part of the portfolio, however, or selling the portfolio slowly over time, may be unattractive to the selling customer for various reasons. In that case, unless the market making dealer is both able and willing to purchase the portfolio (or a portion thereof) as principal, holding the resulting positions in inventory until it is able to sell or hedge them, its customer may be unable to complete the desired transaction and consequently be forced to bear the risks associated with the illiquidity of the positions.

⁵² NYSE Rule 104(f)(ii) (“The function of a member acting as a DMM [a “Designated Market Maker”] on the Floor of the Exchange includes the maintenance, in so far as reasonably practicable, of a fair and orderly market on the Exchange in the stocks in which he or she is so acting. . . . [I]t is commonly desirable that a member acting as DMM engage to a reasonable degree under existing circumstances in dealings for the DMM’s own account when lack of price continuity, lack of depth, or disparity between supply and demand exists or is reasonably to be anticipated.”). Registered market makers on the CBOE are subject to similar obligations. CBOE Rules 8.7(a)-(b).

⁵³ The Agencies requested comment on this topic in Question Nos. 80-82, 87 and 177.

⁵⁴ NPR at 68961. Shortly before this passage, Appendix B of the Proposed Rule provides that “[i]n the context of market making in a covered financial position in an over-the-counter market, a ‘customer’ generally would be a market participant that makes use of the market maker’s intermediation services,” with a footnote going on to state that “depending on the conventions of the relevant market. . . such a ‘customer’ may consider itself or refer to itself more generally as a ‘counterparty.’” *Id.* at 68960, n.2. Although we agree with this statement, we are uncertain as to its intended application to inter-dealer trading.

⁵⁵ *Id.* at 68871. We note that, as discussed above in this section, this would conflict with the regulatory requirements applicable to a NYSE DMM.

- A market maker in liquid markets “continuous[ly]” provides “broadly disseminated” two-sided quotes (in less liquid markets, “regularly” provides quotes, where “regularly” may mean “on a daily or more frequent basis”) and “is registered, if the exchange or organized trading facility registers market makers.”⁵⁶
- For any exchange-traded security, a market maker’s activities are “generally consistent with reasonably expected near-term customer demand when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy.”⁵⁷
- A market maker’s anticipatory trading and inventory management should be “related to clear, demonstrable trading interest of clients, customers, or counterparties” (regardless of market making-related requirements that may be applicable to primary dealers of obligations of foreign governments or other registered market makers).⁵⁸
- A permitted market making-related operation must be designed to generate revenue “primarily from fees, commissions, bid/ask spreads” and other sources not attributable to price movements of positions in inventory or hedging.⁵⁹
- A market maker must be “registered with the SEC” as a dealer, “exempt from registration” or “[e]ngaged in the business of a dealer outside of the United States and subject to substantive regulation of such business in the jurisdiction where the business is located.”⁶⁰

We discuss each of these points in more detail in Sections I.A.1 through I.A.7 and illustrate them with examples.

1. *The suggestion that “market makers. . . typically only engage in transactions with non-customers to the extent that these transactions directly facilitate or support customer transactions” could severely limit the inter-dealer trading that is critical for market making and hedging in many markets.*⁶¹

As we noted in the Introduction, the Proposed Rule effectively disregards the breadth of the statutory language.⁶² In markets in which customer trades are less frequent, inter-dealer trades may be the principal or only reliable source of information about market pricing and depth, and may also represent the only

⁵⁶ *Id.* at 68871-72, n.149.

⁵⁷ *Id.* at 68871-72.

⁵⁸ *Id.* at 68871.

⁵⁹ Section __.4(b)(2)(v) of the Proposed Rule.

⁶⁰ *Id.* at Section __.4(b)(2)(iv)(A).

⁶¹ The Agencies requested comment on this topic in Question Nos. 83 and 86.

⁶² That is, the requirement that permitted market making-related activities be “designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties,” implying that market makers may legitimately trade with counterparties that might not be considered clients or customers, such as other dealers. Section 13(d)(1)(B) of the BHC Act (emphasis added).

available opportunity for dealers to dispose of or hedge the positions that they acquire as a result of customer transactions. As the FSOC Study noted, “While end users are the ultimate beneficiaries of market making activities, market makers are often forced to trade with non-customers in order to appropriately meet the future expected customer demand.”⁶³

Inter-dealer trading can prevent risks from becoming too concentrated in any one dealer (providing a diversification benefit) and can match customer supply and demand through series of transactions involving more than one dealer.⁶⁴ Without inter-dealer trading, market makers would be unable to provide prices (especially distinct bid and offer prices) when customers do enter the market and might have to decline customer trades for lack of a reasonable means of pricing the trade or exiting or hedging the resulting positions.⁶⁵

Because this type of inter-dealer trading is essential for market making, it should certainly qualify as market making-related and therefore be permitted under the statutory standard. Viewed from the perspective of a particular market maker, some inter-dealer trading would in fact not be problematic under the Proposed Rule. For example, a market maker could permissibly engage in inter-dealer trading that was directly related to hedging or exiting a risk position that the market maker had taken from one of its customers. But for there to be an inter-dealer market in the first place, it appears that each dealer that is a banking entity (which includes substantially all the largest and most active dealers) will have to justify each inter-dealer trade individually on the basis of its being directly related to facilitating a transaction of one of *its own* customers. In some cases that requirement might be satisfied, but it is generally problematic given that market makers exist in large part because customers seeking opposite sides of a position are often *not* in the market at the same time and place. In practice, a requirement to justify each inter-dealer trade under the standard of “directly” facilitating or supporting customer transactions would have an immediate chilling effect on inter-dealer markets.

Example 1: inter-dealer trading is an important component of market liquidity. Inter-dealer trading can be vitally important in allowing market makers to facilitate customer trades. Consider a customer wishing to sell a large quantity of investment-grade bonds. Given the size of the transaction, the market maker it approaches (Dealer A) will need to turn to other dealers to find a deep pool of buyers. The Proposed Rule allows Dealer A to sell to a second dealer (Dealer B) because the sale directly facilitates Dealer A’s customer transaction. Dealer B is effectively a source of liquidity for Dealer A’s customer transaction.

However, for Dealer B to buy the securities, it could be the case under the Proposed Rule that Dealer B would independently need to determine that the purchase directly facilitates one of *its own* customer transactions. If it cannot, Dealer B might not be able to buy from Dealer A. The difficulty in

⁶³ FSOC Study at 24.

⁶⁴ Economist Darrell Duffie points out that “[a] market maker is able to provide immediacy more efficiently (at lower cost to clients and at lower risk to itself), through the opportunity to lay off positions with other market makers, who may be better aware of ultimate investors who are interested in trading in the opposite direction. . . . In effect, the inter-dealer network acts as a broader mechanism for transmitting supply and demand shocks from ultimate investors to ultimate investors.” Duffie, *supra* note 50, at 16-17.

⁶⁵ The Agencies requested comment on this topic in Question No. 83.

disposing of the position would be compounded if the size of the customer transaction forced Dealer A to turn to multiple other dealers. This in turn would make Dealer A less willing to buy from the initial customer, or might drive it to charge higher prices. This is not only because Dealer A may have difficulty in reselling or hedging the bonds, but also because the absence of a more robust inter-dealer market will make it more difficult for Dealer A to price the bonds, and it will need to be compensated for that uncertainty.⁶⁶

The FSOC Study noted that inter-dealer trading “can be abused. . . whereby inter-dealer trading is undertaken not for the purposes of market making but rather proprietary trading. A challenge for implementation of the Volcker Rule is thus *distinguishing appropriate volumes of inter-dealer trading for market makers*.”⁶⁷ We agree with this formulation of the issue—and we believe that it supports our emphasis on quantitative trading metrics that measure customer-facing activity, which could be used to determine whether a banking entity is engaged in directly customer-facing business to an extent commensurate with its regulator’s expectations for the particular market after reviewing the metrics for the banking entity’s businesses and taking into account the structure of the relevant markets. We believe there is no practical way to categorically restrict or condition inter-dealer trades by requiring a direct causal link with specific customer trades, as Appendix B of the Proposed Rule suggests.

2. *The Proposed Rule fails to acknowledge the importance of “activities [that] promote price transparency or liquidity,” including inter-dealer trading to maintain efficient markets.*⁶⁸

The Preamble to the Proposed Rule provides that “[t]o the extent that a trading desk or other organizational unit of a banking entity is engaged wholly or *principally* in trading that is not in response to, or driven by, customer demands,” the trading will generally not be permitted market making-related activity, “regardless of whether those activities promote price transparency or liquidity. For example, a trading desk. . . that is engaged wholly or principally in arbitrage trading with non-customers would not meet the terms of the proposed rule’s market making exemption.”⁶⁹

We are not advocating revisiting the prohibition on “bright-line” proprietary trading businesses or creating loopholes for those businesses under the guise that they might “promote price transparency or liquidity” and are therefore market making.⁷⁰ However, we are concerned with the use of a “principally” standard in the commentary quoted immediately above. That standard artificially, and we would argue inappropriately, divides the activities of otherwise market making-related businesses into activities that are “in response to, or driven by, customer demands” and activities that “promote price transparency or liquidity.” For these market making-related businesses, such a distinction is impossible because these

⁶⁶ The Agencies requested comment on this topic in Question No. 351.

⁶⁷ FSOC Study at 24 (emphasis added).

⁶⁸ The Agencies requested comment on this topic in Question No. 86.

⁶⁹ NPR at 68871 (emphasis added).

⁷⁰ Thus, we can understand the Agencies’ statement that a trading desk that is *wholly* engaged “in arbitrage trading with non-customers” would not meet the terms of the Proposed Rule’s exemption.

activities are inextricably linked and cannot be disaggregated or categorized to determine which are “principal.” Accordingly, the final rule should remove the “principally” standard.⁷¹

For example, market makers make trades, often though not exclusively with other dealers, to test the depth of markets at particular price points and understand where supply and demand actually lie. Like the inter-dealer trading discussed above, this type of inter-dealer trading is an essential part of market making and is therefore market making-related. Without it, in many markets a market maker would not be able to provide a customer with accurate prices when the customer seeks to trade.

Example 2: inter-dealer trading allows market makers to test the depth of markets. In markets that trade over the counter, such as interest rates, credit markets and foreign exchange options, prices are determined in the inter-dealer market. Dealers send indications to inter-dealer brokers of prices at which they are willing to trade a specified instrument. Once the prices come in, dealers can view them in one place (“on the screen”). These prices on the screen are often for smaller sizes than a typical customer trade. In part, this is because dealers may not want to signal in advance that they have clients willing to trade in larger amounts. So while the screen provides information on pricing, it does not by itself indicate the extent of demand and supply.

To obtain more information, a dealer will also periodically trade with other dealers to gauge the depth of markets, observing not only buy-ask volume and prices but also the level of continued interest. If a customer contacts the dealer and asks, for example, for bonds in a larger size than the offered amounts on the screen, the dealer would be able to advise the customer whether the market could accommodate the request. This could not be done if the dealer does not regularly trade with other dealers to test the depth of the market.

Trading by market makers to “promote price transparency or liquidity” is critical for maintaining efficient prices, preventing market instabilities and preventing meaningful arbitrage opportunities that could otherwise arise.⁷² Furthermore, the more liquidity a market exhibits, the more stable it tends to be.

⁷¹ Removing the “principally” standard will not create a loophole (for example, for a desk that engaged almost exclusively, but not “wholly,” in arbitrage trading with non-customers) because, as we noted in Section I.A.1 with respect to inter-dealer trading generally, customer-facing activity and other metrics will be available to evaluate whether the relevant trading unit is engaged in directly customer-facing business to an extent that is consistent with the market making-related activities exemption. This “principally” standard is an example of an ambiguous and impracticable qualitative standard that is unnecessary given the availability of better alternatives such as metrics.

⁷² For example, exchange-traded funds (“ETFs”) serve as a cost-effective investment for many market participants, including many retail investors, but they are useful only to the extent that they effectively track the price of their respective underlying assets. Trading by market makers helps maintain this alignment because they have the capacity and knowledge of the relevant markets to quickly trade to eliminate price discrepancies that may arise. As another example, trading by market makers helps ensure that the prices of American Depositary Receipts (“ADRs”) correctly reflect the prices of their respective underlying ordinary shares trading on the relevant non-U.S. exchanges.

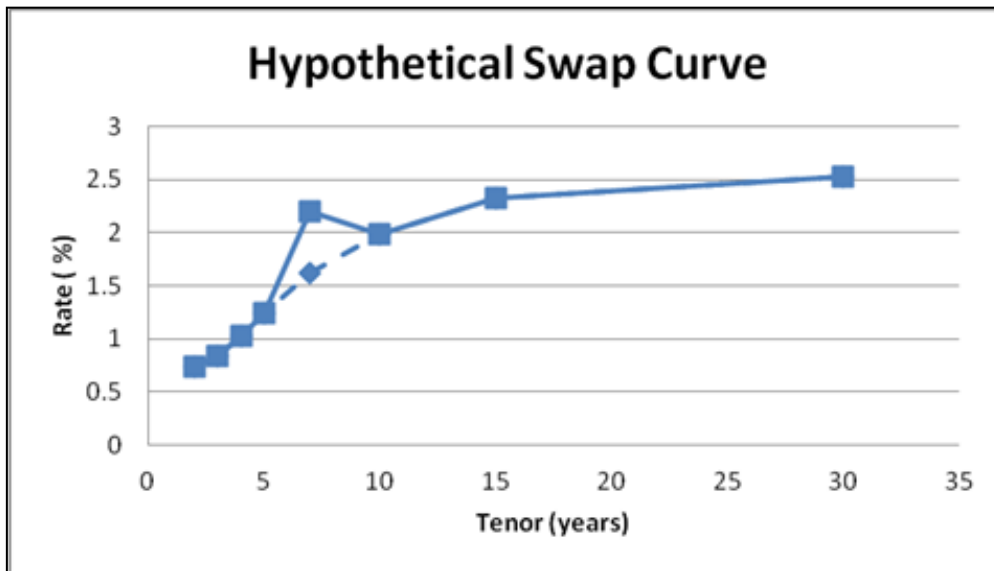
On this subject, we note that foreign ETFs may be subject to the Proposed Rule’s restrictions on certain interests in hedge funds and private equity funds because of the breadth of the Agencies’ proposed definition of “foreign funds.” Under that definition, banking entities would effectively no longer be able to be make markets in foreign

(footnote continued)

Non-financial businesses, in particular, depend on predictable and stable market conditions to ensure affordable access to capital markets. If financing costs, the costs of commodity inputs and the dollar value of imports and exports cannot reasonably be predicted or efficiently hedged, business planning will become less reliable and businesses will not undertake investments that they might otherwise have undertaken.

Example 3: market makers maintain efficient prices and prevent arbitrage opportunities: interest rate swaps. Fixed-for-floating interest rate swaps allow companies or investors to better align their exposures to interest rate movements. Interest rate swaps exist with different maturities, and their price varies depending on the maturity term. The interest rate “swap curve,” which charts their prices as a function of the duration of the swaps, is typically a smooth line.⁷³

Frequently, however, closely related financial instruments have different levels of liquidity. In such cases demand from customers to pay the fixed rate on the less liquid swap (to lock in the cost of a floating-rate debt issuance, for example) could create a “kink” on the swap curve, as shown in the hypothetical swap curve below:



This result is inefficient. In this particular example, the dislocation on the curve would make it more expensive for those looking to borrow money for 7 years. For a borrower seeking a certain asset-liability profile, borrowing for 10 years may not be an ideal solution, even if it is cheaper. More broadly, the increased volatility around any particular point on the curve would add to uncertainty and the costs of hedging for all customers.

(footnote continued)

ETFs, and liquidity in those products would consequently decline when banking entities exit those markets. Our proposal to narrow the definition of “foreign funds” is discussed in detail in our separate letter on the hedge fund and private equity fund provisions of the Proposed Rule.

⁷³ The swap prices are generally a function of the theoretical “fair value” associated with a forecast of short-term rates, plus a concession or premium for supply and demand.

Market makers can reduce this inefficiency and its consequent potential for volatility. Market makers intervene to provide liquidity “selling” the 7-year swap and hedge by buying the 5- and 10-year swaps. This smoothes the swap curve, improves market efficiency, and provides more certainty to market participants. It also decreases volatility and bid-offer spreads for customers. (Note that to “sell” the 7-year swap and hedge using the 5- and 10-year swaps, a market maker would often need to trade with other dealers and thereby access the liquidity provided by inter-dealer markets. As was the case in Example 1, the inter-dealer trading in this example would ultimately serve to reduce costs for customers.)

Customer-facing activity metrics, including the Inventory Risk Turnover metric, together with the knowledge of a banking entity’s trading businesses that regulators develop as part of the supervisory process, will put trading for price discovery and market depth in context and allow for an adequate evaluation of the extent to which it is consistent with market making-related activities for a particular market. Accordingly, the final rule should remove negative presumptions against such trading.

- 3. The requirement to “hold oneself out as being willing to buy and sell” must be broad enough to work across asset classes and different transaction sizes and, in particular, should be less focused on exchange registration and dissemination of unsolicited price quotes as the primary determinants of compliance.⁷⁴*

We noted above that the Proposed Rule’s narrow view of market making appears to be based largely on the model of highly liquid and exchange-traded, large-capitalization U.S. equity markets. Even within the U.S. equities markets, however, there exist many different types of liquidity (for example, small-capitalization, unlisted or derivatively priced securities like ETFs) and types of trading (for example, trading in less than block sizes, block positioning and off-exchange trading). The Proposed Rule’s requirements are problematic because they appear to confuse two very different types of market making. One type is performed by registered exchange-based market makers, also known as “specialists” or “floor-based” market makers, such as NYSE DMMs, holding themselves out in less than block size. These registered market makers agree to play a specialized, narrowly prescribed role in making price quotes and filling orders on the relevant exchange. The other type is performed by so-called “upstairs” market makers,⁷⁵ who provide liquidity to customers and are generally willing to buy and sell on demand, but do not always provide prices unless requested to do so and are not necessarily registered as market makers in any particular trading venue.

The Volcker Rule regulations should—and, in many places, the Proposed Rule does—focus on the latter type of market making, in which market makers provide liquidity and facilitate customers’ transactions across a market as a whole, not solely on any one exchange or trading platform. Yet some of the Proposed Rule’s commentary appears to blur the distinction between “specialist” market making in less than block size and market making more generally. For example, Appendix B of the Proposed Rule provides that “market making-related activities generally involve. . . acting as a registered market maker, where [the

⁷⁴ The Agencies requested comment on this topic in Question Nos. 85 and 91.

⁷⁵ These markets makers may sometimes be, but are not always, acting in the capacity of a block positioner.

relevant] exchange or organized trading facility provides the ability to register as a market maker.”⁷⁶ Similarly, the Preamble to the Proposed Rule suggests that a market maker in liquid products should “continuous[ly]” make “broadly disseminated” two-sided quotes and, even in “less liquid markets,” “regularly” make quotes.⁷⁷

Neither of these statements is representative of most types of market making. Furthermore, the style of market making in which “specialist” market makers engage may not be customer-facing at all. For example, NYSE DMMs are in fact generally prohibited from dealing with customers; companies must “wall off” any trading units that act as DMMs.⁷⁸ These and other registered exchange-based market makers effectively hold themselves out to *other dealers*, not customers. Although this is important for maintaining liquid and orderly markets, it is not appropriate as a model for permitted market making-related activities under the Volcker Rule, which contemplates trading with “clients, customers, [and] counterparties.”⁷⁹

Whether a transaction is executed on an exchange should not, in itself, affect the analysis of whether that transaction is market making-related. Even for exchange-traded securities, providing liquidity to customers may involve trading away from the most active exchange, on smaller exchanges, in OTC markets or through electronic communication networks and alternative trading systems. In fact, there are more than 12 exchanges and 40 alternative trading systems currently trading U.S. equities alone. Market makers need to be able to trade in those venues to maintain liquidity across the markets as a whole and provide customers with favorable pricing.⁸⁰ Moreover, the requirements for the market making-related activities exemption are essentially all oriented toward determining whether a banking entity’s activities are substantively consistent with market making. In view of these factors, there is no need for commentary implying that the banking entity must formally register as a market maker with every exchange on which it trades. Instead, that commentary should be removed from the final rule in favor of a focus on substantive activities as measured by quantitative trading metrics.

Apart from the issue of exchange registration, the Proposed Rule places far too great an emphasis on the dissemination of unsolicited price quotes as the primary indicator of “holding oneself out as being willing to buy and sell.”⁸¹ This is true even for U.S. equities, but is particularly problematic for other asset

⁷⁶ NPR at 68960.

⁷⁷ *Id.* at 68870-71.

⁷⁸ See NYSE Rule 98.

⁷⁹ Conversely, if a banking entity is registered as a market maker on an exchange, that status should be given positive treatment and should confer a presumption that the trading activity of the relevant trading unit is market making-related. This presumption is warranted in view of the fact that registered market makers directly contribute to maintaining liquid and orderly markets and are subject to extensive regulatory requirements in that capacity.

⁸⁰ The Agencies requested comment on this topic in Question No. 93.

⁸¹ Furthermore, we note that for purposes of the SEC’s Regulation SHO—where, as the Agencies point out, a similar “holding out” criterion is used to define market making—market making is a condition to a special exemption from short-selling “locate” requirements that are otherwise generally applicable. In other words, the market making definition under Regulation SHO (derived from Section 3(a)(38) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) is narrow because it creates a narrow exemption. The same criterion does not work well for the Volcker Rule. (The Agencies requested comment on this topic in Question No. 88.) In essence, Regulation SHO provides that a specified subset of all market makers will be exempt from “locate” requirements, but does not provide that *other* market makers may not engage in any market making activities; they may, but they
(footnote continued)

classes that simply do not operate in that manner.⁸² For example, an issuer may have one listed equity security, but dozens of outstanding debt issuances, with various rates, maturities and other terms.⁸³ In credit markets, a market maker will typically disseminate indicative prices for the most liquid instruments, which amount to a small subset of the market, but not for thousands of other instruments that trade only infrequently.⁸⁴

The market maker may, however, be willing to trade in the illiquid instruments. Market participants are well aware that a market maker will generally provide a price for a trade if asked. For example, if a banking entity operates a U.S. credit market making business, clients, customers and counterparties know, typically because of the presence of a banking entity's sales force, that they can call the banking entity and ask to purchase credit products and likewise can show the banking entity a single instrument or a portfolio of instruments that they are looking to sell, and the banking entity will provide indicative prices to the client, customer or counterparty.

On the other hand, if the U.S. credit market making business were required to produce and disseminate price indications for many thousands of individual bond CUSIPs, when some never trade and most trade very infrequently—and, on top of that, design and implement an independent compliance regime to ensure that this requirement is being met—it would represent a massive burden.⁸⁵ Even more

(footnote continued)

must then comply with the “locate” requirements in doing so. Under the Volcker Rule, in contrast, the market making exemption will be the only gateway to market making activities for many banking entities. Although the definition of market making under the Volcker Rule must exclude prohibited proprietary trading, in contrast to Regulation SHO, we believe there is not a corresponding interest in defining market making more narrowly than is necessary to achieve this goal.

⁸² The Agencies requested comment on this topic in Question No. 92.

⁸³ Fixed income asset manager Income Research & Management (“IR&M”) noted the following with respect to corporate bonds: “As of 12/31/2011, the thirty constituents of the Dow Jones Industrial Average have 1,169 debt instruments outstanding collectively; by ISIN, bonds outnumber stocks by nearly 39 to 1 in this sample. Maturity dates of the debt instruments sampled range from early 2012 to 2097. Some of these bonds are callable, some are puttable, some are convertible into stock, and some pay a fixed coupon while others pay a coupon that resets periodically. Daily trading volumes for specific issues in this sample range from zero to greater than \$100 million in par value.” Comment letter on the proprietary trading prohibition of the Volcker Rule submitted by IR&M on January 20, 2012, p. 2.

⁸⁴ Oliver Wyman found that, out of nearly 16,000 U.S. corporate bonds traded in 2009, nearly half were traded on no more than 10 days during the year. Only about 1,000 of the bonds were traded on at least 150 days during the year. Oliver Wyman also noted that “a disproportionate number of the low volume bonds belong to small issuers (60% of bonds that traded fewer than 10 days were issued by companies outside the Fortune 500 vs. 30% of bonds that traded more than 200 days) making principal-based intermediation particularly critical for these companies.” Oliver Wyman, *supra* note 22, at 9.

Commodities, interest rate, foreign exchange and other products can also have numerous combinations of size, underlying assets, maturities, delivery dates and other terms. In these cases, there might be a reasonable volume of total trading (for example, in a particular issuer's debt, or in a certain type of oil derivative in the spot markets), but relatively few trades in any particular instrument (for example, “off the run” bonds, out-of-the-money options and long-dated derivatives, which customers and end users may nonetheless want to hold as investments or use to hedge their risks).

⁸⁵ The Agencies requested comment on this topic in Question No. 84.

fundamentally, it would have almost no bearing on the quality of the banking entity's customer facilitation, because most customers would have no use for virtually all the indicated prices.⁸⁶ As another example, for many interest rate products there is effectively no limit on the number of different maturities at which the products may be traded. A particular type of interest rate swap, for instance, may exist for almost every conceivable maturity. Yet market makers in these products do not disseminate unsolicited price indications for all possible maturities because, again, it would be a massive burden and there would be little or no demand for the vast majority of them.⁸⁷

To address the concerns described above, we suggest that the final rule eliminate price-quoting as a primary determinant of market making and instead provide that the "holding out" criterion will be satisfied, with respect to a particular covered financial position, if a banking entity is in the business of providing prices upon request for that covered financial position or other covered financial positions in the same or similar asset or product classes.

4. *Market makers engage in both "active" and "passive" trading (a distinction that has little meaning when applied to many asset classes and markets, particularly non-U.S. markets).*⁸⁸

In discussing market makers' trading on an organized trading facility or exchange, Appendix B of the Proposed Rule describes a distinction between providing liquidity (using "resting" orders and earning rather than paying fees, commissions and spreads) and taking liquidity (using "market" or other "active" orders and potentially paying rather than earning a greater proportion of fees, commissions and spreads).⁸⁹ This distinction is intended to differentiate between permitted market making-related activities and prohibited proprietary trading activities. The Preamble to the Proposed Rule goes further and states that, with respect to trading on exchanges, a "market maker's activities are generally consistent with reasonably expected

⁸⁶ The Preamble to the Proposed Rule appears to refer to OTC bond markets as "less liquid" and to imply that a market maker would therefore generally be expected to provide "regular" ("daily or more frequent") quotes. NPR at 68871, n.149. As we have noted, this is not only factually inaccurate as a description of market making in OTC bonds, but also neglects to recognize that there is a wide range of liquidity of instruments that are traded (with greater or lesser frequency) in that market. The Preamble also notes that "*highly illiquid* markets may trade only by appointment." *Id.* (emphasis added). This is still problematic since a market maker may not regularly provide quotes for less liquid instruments in markets such as credit, even though the market as a whole is not necessarily *highly illiquid* (however one might construe that term). The same is true in interest rates and other markets.

⁸⁷ This dynamic is even more pronounced for tailored (or "bespoke") instruments, such as customized credit protection on a designated portfolio of securities, which are designed on request to meet a customer's unique needs and therefore would generally never be priced by a market maker before the customer asks for a price.

Another indication of market making-related activities cited by the Preamble to the Proposed Rule in connection with the "holding out" requirement is "[t]ransaction volumes and risk proportionate to historical customer liquidity and investments [sic] needs" (*id.* at 68871). We note that, as with new or customized products, this historical information will not necessarily be available for new businesses or developing markets in which a market maker may seek to establish trading operations.

⁸⁸ The Agencies requested comment on this topic in Question Nos. 86, 178, 179 and 181.

⁸⁹ See NPR at 68960.

near-term customer demand when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy.”⁹⁰

This commentary about “passively providing liquidity” is another example of language that may describe some of the activities of registered exchange-based market makers such as NYSE DMMs, but is not true of market makers generally.⁹¹ For example, a market maker may purchase a large equity block from a customer and resell it in smaller lots on the NYSE (or other exchanges). Here, the market maker’s goal is to efficiently resell the equity block so as to close out the risk position that it took from its customer. It does not follow that the market maker would be registered as a market maker on any of the relevant exchanges or that it would necessarily use only limit orders or other “passive” trades to do so.

Effective market making requires a market maker to have the ability to engage in both “active” and “passive” trading, particularly in less liquid markets. Even in liquid markets, market making requires a range of order types, including market orders and marketable limit orders that might not be considered “resting.” Market makers may also “actively” trade to test the depth of markets, to accumulate or dispose of inventory or to ensure that ETFs, ADRs, options and other instruments remain appropriately priced in relation to their respective underlying instruments. Moreover, the infrastructure of some trading platforms, especially in Europe, Asia and other non-U.S. jurisdictions, is such that there is no concept of a “limit” order and consequently no cognizable distinction between “active” and “passive” orders.

This is another area in which quantitative trading metrics should be used to compare, in the aggregate and over time, the liquidity that a market maker makes rather than takes as part of a broader consideration of the market making character of the relevant trading activity. For example, the spread-related metrics such as Spread P&L might be considered for this purpose. The most important result, in our view, is preserving flexibility to find and adapt, as changing market conditions necessitate, the appropriate threshold for liquidity-taking activities in each asset class and market. Accordingly, the commentary about “active” and “passive” trading should be removed from the final rule and, as discussed throughout this letter, regulators should instead look to quantitative trading metrics.

5. *The exemption for market making-related activities should not inhibit effective inventory management through overly restrictive anticipatory trading and block resale requirements, and should expressly cover the trading obligations of primary dealers of sovereign obligations.*⁹²

Market makers must manage the inventories of positions they have taken as principal, which, if done effectively, also allows them to accommodate customers’ trades quickly and at favorable prices. Gradually disposing of a large long position purchased from a customer may be the best means of reducing the near-term price volatility associated with the supply shock of trying to sell it all at once. Similarly, gradually accumulating long positions in anticipation of a large sale to a customer, or of short positions in anticipation of a large purchase from a customer (rather than selling after the fact), is often the best strategy for maintaining an orderly market and providing the best prices to customers. The suggestion that such

⁹⁰ *Id.* at 68871. This suggests that, under the Proposed Rule, activities that do not fit this description would generally be inconsistent with reasonably expected near term customer demand.

⁹¹ The Agencies requested comment on this topic in Question Nos. 177 and 184.

⁹² The Agencies requested comment on this topic in Question No. 89.

anticipatory trading must be “related to clear, demonstrable trading interest of clients, customers or counterparties” is too restrictive and may unduly hamper market makers’ ability to manage their inventories effectively. It is also inconsistent with the statute’s description of “*reasonably expected* near term demands of customers, clients or counterparties.”⁹³

The following are situations, which are not necessarily specific to any particular asset class or trading venue, in which market makers require discretion to accumulate and manage inventory, including through anticipatory trading, to better serve their customers.⁹⁴

Example 4: large block positions require market makers to manage inventory. Larger dealers are often the only sources of liquidity for block positions, which mutual funds and pension funds buy or sell to meet redemptions and payment obligations or to rebalance their portfolios in response to changing market conditions. Market makers may have relationships with both buyers and sellers in the relevant positions as well as the expertise and incentive to provide supply and demand to both sides without disrupting the market. Market makers today build and manage inventories on an ongoing basis before customers commit to a block trade. If they are only able to do this in response to a customer trade (or after a customer directly inquires about it so as to show “clear, demonstrable trading interest”), customers will suffer from increased execution time, along with worse pricing and higher price volatility.

Executing a block trade also requires market makers to prudently manage their inventory to reflect prevailing market liquidity, avoid disrupting the market and protect the customer’s trading strategies. The Proposed Rule constrains this prudent inventory management. If market makers are uncertain about the permissibility of accumulating and disposing of these blocks in a gradual manner, they will provide less favorable size and pricing terms to customers or may even decline to execute certain trades at all.

If investors cannot sell block positions to market makers, they will need to unwind the positions on their own. This means that they will either hold the positions for longer than they would like, or alternatively that they will dispose of the positions quickly, resulting in lower prices and a lesser amount of proceeds. Either directly or indirectly, this will drive investment costs higher and returns lower, eroding investment returns and wealth.

Example 5: inventory management is required to create structured products. Market makers accumulate inventory to create “units” for structured products, such as asset-backed securities and ETFs, including many that are purchased by retail customers. Acting as market maker in this capacity requires anticipatory accumulation of the underlying components of these products, which are then packaged into units to meet customer demand. Again, if market makers could not maintain an

⁹³ As we noted above, “clear [and] demonstrable” is inconsistent with the statutory standard of “reasonably expected.” Furthermore, a market maker may often, in fact, be unable to trade in a position immediately in advance of a customer order because to do so could constitute impermissible front-running. Therefore, restricting all anticipatory trading to that time period might, as a practical matter, prohibit all anticipatory trading, to the detriment of the markets.

⁹⁴ The Agencies requested comment on this topic in Question No. 83.

inventory of these underlying components, acquiring (or disposing of) large volumes of them all at once would hurt execution times and prices to customers. It would also be disruptive to the markets as these derivatively priced assets, like ETFs, often do not have any other posted liquidity other than from market makers. And a large order routed to electronic exchanges could cause severe dislocations of market prices.

The Preamble to the Proposed Rule states that market making-related activity “would include block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading,”⁹⁵ but also references (as “guidance”) the SEC’s definition of “qualified block positioner” from Rule 3b-8(c) under the Exchange Act. This definition carries the requirement that a qualified block positioner resell a block position “as rapidly as possible commensurate with the circumstances.”⁹⁶ This latter requirement, like the description of block positioning in the Preamble to the Proposed Rule, is not necessarily inconsistent with a longer unwind of a block position, but creates uncertainty about whether and under what specific circumstances the longer unwind would in fact be permissible. This uncertainty about trading out of customer positions after the fact, together with the restrictions on anticipatory trading before the fact, threatens to put market makers in a position in which they have little incentive to properly facilitate customer trades.⁹⁷

Quantitative trading metrics will provide for measurements such as Inventory Risk Turnover, through which regulators may evaluate the length of time that a trading unit tends to hold risk positions in inventory and whether that length of time is consistent with market making-related activities in the relevant market.⁹⁸ We recommend that the final rule explicitly state that a trading unit’s inventory management practices will be evaluated using this metric, in conjunction with others, and remove the references to “clear, demonstrable trading interest” and the SEC definition of “qualified block positioner” (leaving the more general and accurate statement, without the cross-reference to the SEC definition, that market making-related activities “would include block positioning. . . for the purpose of intermediating customer

⁹⁵ NPR at 68871.

⁹⁶ *Id.* at 68871, n.151.

⁹⁷ From the customer’s perspective, AllianceBernstein noted this concern in the context of fixed income markets: “[O]ne of our greatest concerns is the devastating effect that the [Proposed Rule] would have on the fixed income markets that exhibit intermittent liquidity and thus require market makers to act as principal in order to ensure liquidity. . . . The ability of corporate issuers to place their debt securities in the US capital markets is fundamentally dependent on the availability of adequate secondary market liquidity for these securities. Purchasers of these securities, including large pension funds, mutual funds, insurance companies and college and other endowments, and their investment managers, are willing to purchase these securities only because of adequate secondary market liquidity (so that they can meet their ongoing cash needs) which depends in large part on the market making activities of banking entities. We believe that any significant reduction in liquidity provided by market makers will, until another source of liquidity develops, have a dramatic adverse impact on the ability of corporate issuers to access needed funds in the US capital markets. We are convinced that the [Proposed Rule] will in fact significantly reduce the liquidity of the secondary market for debt securities and is likely to have a profound and unintended adverse effect on our capital markets.” AllianceBernstein, *supra* note 20, at 4.

⁹⁸ The Agencies requested comment on this topic in Question No. 94.

trading”⁹⁹). Furthermore, the Proposed Rule provides that, subject to the conditions that we have noted, “market making-related activity may include taking positions *in securities* in anticipation of customer demand.”¹⁰⁰ Although we do not believe that the Agencies intended to exclude covered financial positions other than securities, the final rule should change the reference to “covered financial positions” to avoid any ambiguity.

The Agencies also asked whether the final rule should adopt any additional exemptions for trading in the obligations of foreign governments or international and multinational development banks and, if so, how such an exemption would promote and protect the safety and soundness of banking entities and the financial stability of the United States.¹⁰¹

We believe it should. As we noted in the Introduction, we are a primary dealer in 18 countries around the world, including the United States. Many countries, including the United States, designate responsibilities in connection with primary dealer status; we are concerned that these responsibilities could conflict with the Proposed Rule, particularly its provisions relating to inventory management for market makers.¹⁰² Primary dealer obligations may require us to trade as principal to maintain a secondary market, or to purchase a certain percentage of a foreign sovereign debt issuance even if, at the time, we may not expect to completely resell our allotment of the issuance to third parties.

Allowing foreign banks to serve as primary dealers facilitates the distribution of a sovereign’s securities to the broadest possible international investor base.¹⁰³ This reduces the cost of capital for the sovereign and helps to ensure an active market in the securities.¹⁰⁴ Just as the United States would not want fewer foreign dealers serving as primary dealers of U.S. government obligations, other governments would not—and clearly do not—want the Volcker Rule to impose restrictions on their own primary dealers or harm the markets for their own debt.¹⁰⁵ If the exemption for market making-related activities is not clearly

⁹⁹ NPR at 68871.

¹⁰⁰ *Id.* (emphasis added).

¹⁰¹ The Agencies requested comment on this topic in Question No. 122.

¹⁰² For example, primary dealers in the United States are expected to “participate consistently as counterparty to the [FRBNY] in its execution of open market operations to carry out U.S. monetary policy pursuant to the direction of the [Federal Open Market Committee]. . . participate in all auctions of U.S. government debt; and make reasonable markets for the [FRBNY] when it transacts on behalf of its foreign official account holders.” FED. RESERVE BANK OF N.Y., OPERATING POLICY FOR ADMINISTRATION OF RELATIONSHIPS WITH PRIMARY DEALERS, § I (2010).

¹⁰³ The FRBNY’s current list of primary dealers of U.S. government obligations, for example, contains several Canadian, European and Asian dealers.

¹⁰⁴ U.S. Treasuries are among the most liquid assets in the world, in part because of the strong network of primary dealers supporting their liquidity. Oliver Wyman found that, in 2010, the annual trading volume in U.S. Treasuries was approximately 1,420% of the average total value outstanding, or approximately 12 times more than for equities and almost 30 times more than for corporate debt. Oliver Wyman, *The Volcker Rule: Implications for the U.S. corporate bond market* 7 (Dec. 2011).

¹⁰⁵ Financial officials in several countries have raised concerns on this matter. Writing for the European Commission, Commissioner for Internal Market and Services Michel Barnier expressed a “very strong concern” about the “absence of an exemption [from the Volcker Rule] for non-US bonds,” which he argued “would have a negative impact on the liquidity of non-US sovereign markets.” He thus requested that “EU Government securities be given
(footnote continued)

broad enough to include trading in non-U.S. sovereign debt, there will be a strong disincentive for banking entities subject to the Volcker Rule to be primary dealers outside the United States. This could reduce liquidity and raise sovereign borrowing costs. In current market conditions, and at times in the future, this could destabilize markets and harm the safety and soundness of U.S. banking entities and ultimately the financial stability of the United States.

The Agencies should seek to retain all tools for maximizing the depth of markets in sovereign debt from around the world, which includes preventing the Volcker Rule from disrupting primary dealer markets. One way to accomplish this would be to exempt non-U.S. sovereign debt, similarly to the way U.S. government securities are treated under the Proposed Rule. If non-U.S. sovereign debt is not exempted altogether, the final rule should clarify that when a banking entity engages in trading activities as a primary dealer of foreign sovereign debt, its primary dealer activities will be considered to be undertaken in response to near term demands of a client, customer or counterparty (in this case, the sovereign). Furthermore, with respect to a primary dealer's trading activities in the sovereign debt, the final rule should acknowledge that such activities are valid market making-related functions that a primary dealer may be obligated to undertake to maintain an orderly market and to prevent or correct any pricing dislocations.¹⁰⁶

(footnote continued)

the same treatment [under the Volcker Rule] as US Government securities." Comment letter submitted by Michel Barnier on February 8, 2012, p. 2.

In a joint letter, the Financial Services Agency of the Government of Japan (the "JFSA") and the Bank of Japan (the "BoJ") expressed their concern that the absence of an exemption for government bonds other than U.S. Treasuries would have an adverse impact on trading in the Japanese Government Bonds (JGB) market, a \$12 trillion dollar market. They too requested that the exemption for U.S. Treasuries be expanded to include JGBs. They also noted the risk that the Proposed Rule might lead Japanese banks to curtail their U.S. operations and Japanese subsidiaries of U.S. banks to exit from JGB trading. Comment letter submitted by the JFSA and the BoJ on December 28, 2011. From a global perspective, the JFSA and the BoJ noted the possibility of "extremely negative pressures on sovereign bond markets worldwide through reduced liquidity and a rise in volatility. Such a situation would be particularly worrisome under the current financial market condition." *Id.*

In addition, the Office of the Superintendent of Financial Institutions Canada (the "OSFI") has also commented that "[m]any foreign banks play important market-making roles in the trading of government securities in their home jurisdictions" and advocated for the exemption of foreign government securities from the restrictions on proprietary trading, at least for banking entities with a non-U.S. parent bank. Comment letter submitted by the OSFI on December 28, 2011, p. 2. According to the OSFI, the absence of such an exemption "would undermine the liquidity of government debt markets outside of the US and could significantly impede the ability of foreign banks to efficiently manage their liquidity and funding requirements at an enterprise-wide level." *Id.* at 3.

Similarly, the Investment Industry Association of Canada (the "IIAC") wrote, "The Volcker restrictions on proprietary dealing in Canadian government securities are of particular concern to the Canadian banks and investment industry. . . . [Those restrictions] will result in more restrained market-making activity, interfering with the efficiency and liquidity of the traded marketplace. . . . The damaging impact on market-making activity would adversely affect the liquidity and pricing of Canadian debt for U.S. [and] Canadian issuers and investors alike." Comment letter submitted by the IIAC on December 21, 2011, pp. 3-4.

¹⁰⁶ See *supra* note 52.

6. *The sources of a market maker's revenues vary so much across asset classes and markets that a "primarily from fees, commissions, bid/ask spreads" standard is inappropriate.*¹⁰⁷

The Proposed Rule requires that market making-related activities be "designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to . . . [a]ppreciation in the value of covered financial positions. . . or [t]he hedging of covered financial positions."¹⁰⁸

Although Appendix B of the Proposed Rule acknowledges that the proportion of "customer revenues" relative to total revenues will vary by asset class,¹⁰⁹ the wording of the Proposed Rule itself does not appear to be consistent with this acknowledgment. Instead, the Proposed Rule effectively divides revenues into two classes: those that are not attributable to appreciation in the value of, or hedging of, covered financial positions, and those that are. If the former must be "primary," the latter cannot be. In other words, it is difficult to read the Proposed Rule as other than requiring that "primarily" means "more than 50%." This could be read to belie Appendix B's more appropriate suggestion that the standard should be flexible.

When trades are infrequent and prices are not transparent, as is often the case in less liquid markets, it is difficult, if not impossible, to distinguish between revenues derived from bid-offer spreads and revenues derived from price movements. It is therefore difficult to establish a basis for distinguishing between customer revenues and non-customer revenues. Furthermore, the nature of some markets is such that, even where "customer revenues" are reasonably discernable, there may not be a reasonable expectation of deriving the majority of revenues from "customer revenues," let alone that non-customer revenues will be only "incidental."¹¹⁰ For example, because demand for commodities is fairly inelastic in the short term, prices of commodities and commodity derivatives may fluctuate substantially. In these cases, profits and losses from price movements in market makers' positions, no matter how closely they are related to specific customer trades, may be more than "incidental" and potentially more than customer revenues entirely.¹¹¹ This is also true in markets in which market makers cannot quickly "trade out" of risk positions

¹⁰⁷ The Agencies requested comment on this topic in Question No. 96.

¹⁰⁸ Section __.4(b)(2)(v) of the Proposed Rule (emphases added). Additionally, "[t]he compensation arrangements of persons performing the market making-related activities [must be] designed not to reward proprietary risk-taking." *Id.* at Section __.4(b)(2)(vii). Systemically important banking entities determine compensation according to comprehensive firm-wide policies that, consistent with Federal Reserve Board regulations, are designed to ensure that the banking entities have effective controls and risk management and to be consistent with safety and soundness principles. This, combined with appropriately calibrated Volcker Rule quantitative trading metrics, should ensure that compensation arrangements are not designed to reward prohibited proprietary risk-taking. The Agencies requested comment on this topic in Question No. 97.

¹⁰⁹ NPR at 68960-61 ("The appropriate proportion of 'customer revenues' to profits and losses resulting from price movements of retained principal positions and risks varies depending on the type of positions involved, the typical fees, commissions, and spreads payable for transactions in those positions, and the risks of those positions. As a general matter, the proportion of 'customer revenues' generated when making a market in certain positions increases as the fees, commissions, or spreads payable for those positions increase, the volatility of those positions' prices decrease, and the prices for those positions are less transparent.").

¹¹⁰ *Id.* at 68960.

¹¹¹ We further note that Appendix B of the Proposed Rule, which provides that "[a]bsent explanatory facts and circumstances, particular trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risk, rather than customer revenues, will be considered to be prohibited proprietary trading" (*id.* at 68962), seems to shift the emphasis of the revenue test from the design of

(footnote continued)

taken from customers. In the CDS market, for example, which has relatively low trading volumes but includes customers seeking to make large trades, the FRBNY found that market makers “who are willing to take on a position in a rarely traded asset” were particularly important for providing liquidity, although they “typically hold on to risk taken on in customer trades for some time before hedging” and follow an approach of “trading out of positions gradually.”¹¹²

Thus, the final rule should remove the “primarily” standard as well as any negative presumptions based on revenues. Instead, revenue metrics such as Spread P&L, when feasible to calculate, should be analyzed in the context of the market maker’s other quantitative trading metrics, along with the knowledge of a banking entity’s trading businesses that regulators will have developed as part of the supervisory process.

Finally, revenues associated with hedging should not categorically be excluded from “customer revenues” for non-derivative positions. The Proposed Rule provides that customer revenues include “the difference between the cost of entering into the derivative contract and the cost of hedging incremental, residual risks arising from the contract,”¹¹³ and therefore recognizes that, with respect to derivatives transactions, the effective “spread” consists of a market maker’s profitably hedging a position taken from a customer. This guidance should apply equally to non-derivative positions, from which a market maker may also realize customer revenues through profitable hedging.

*7. The Volcker Rule should not require substantive, dealer-specific regulation for market makers.*¹¹⁴

The Proposed Rule generally requires that a banking entity relying on the market making exemption for securities trading either (i) be registered with the SEC as a dealer with respect to the trades in question (or exempt from such registration) or (ii) be engaged in the business of a dealer outside of the United States and be subject to “substantive” regulation of its dealing business in the jurisdiction in which the business is located.¹¹⁵

The preceding discussion explained some of the reasons why dealers engaged in market making need to be active in many markets and on many platforms, even when those are not their primary trading venues and trading volumes in those venues may be limited. They may trade in certain markets and on certain platforms through legal entities other than their SEC- or CFTC-registered dealer entities. In addition, there are no uniform definitions of “dealer” or “market maker” in the various jurisdictions around the world, and regulatory regimes addressing trading practices differ markedly. Some jurisdictions cannot be said to have “substantive” dealer regulation regimes (some for all asset classes and others with respect to specific

(footnote continued)

trading activities, per Section __.4(b)(2)(v) of the Proposed Rule, to actual outcomes. If a revenues test is retained in the final rule, this discrepancy should be resolved by conforming Appendix B to Section __.4(b)(2)(v), which focuses on how market making-related activities are designed to generate revenues.

¹¹² Chen et al., *supra* note 38, at 2, 10, 17.

¹¹³ NPR at 68960.

¹¹⁴ The Agencies requested comment on this topic in Question Nos. 95 and 178.

¹¹⁵ Section __.4(b)(2)(iv)(A) of the Proposed Rule; the comparable requirements for swaps and security-based swaps trading are set forth in Sections __.4(b)(2)(iv)(B) and __.4(b)(2)(iv)(C), respectively.

asset classes), in which case international dealers in those jurisdictions could not qualify for the market making-related activity exemption under the Proposed Rule.¹¹⁶ That could prevent us from transacting at all in some international markets.

Accordingly, the Agencies should eliminate the substantive, dealer-specific regulation requirement—which is not necessitated by the statutory language of the Volcker Rule—for banking entities engaged in market making-related activities. At a minimum, this requirement should not apply to dealers in non-U.S. jurisdictions to avoid overly broad disqualifications of international dealers that engage in market making-related activities.

B. Permitted Underwriting Activities

The Proposed Rule recognizes that underwriting services and related syndicate activities are essential for capital formation and for the smooth functioning of markets both in the United States and elsewhere.¹¹⁷ We are concerned, however, that the exemption for underwriting-related activities included in the Proposed Rule is narrower than the Agencies seem to have intended.¹¹⁸ If the exemption is too limited, and underwriters have fewer tools to help issuers to raise capital and support an orderly aftermarket, issuers' cost of capital will rise and shareholder returns will fall.

We believe the changes needed in the final rule are straightforward:¹¹⁹

- **Definition of “distribution”:** The “distributions” that may be underwritten under the Volcker Rule should include all primary issuances as well as all Regulation M “distributions.”¹²⁰ The Regulation M definition may be too narrow to capture the full range of capital-raising transactions, such as private placements, that the Preamble to the Proposed Rule indicates should be covered.
- **Underwriting syndicate activities:** The final rule should expand the definition of “underwriter” to include other “distribution participants” as defined in Regulation M, and remove the requirement that underwriting activities must be “solely” in connection with the underwriting.¹²¹ This is

¹¹⁶ In addition, as discussed in Section III.C, a banking entity may execute customer trades through an international dealer but, for capital adequacy and risk management purposes, book the position in another non-U.S. entity that is not “engaged in the business of a dealer.”

¹¹⁷ NPR at 68925 (“The Agencies anticipate that the proposed approach to implementing the underwriting exemption should permit legitimate forms of underwriting in which market participants currently engage and, thus, should not unduly burden capital formation. In addition, the proposed rule would permit underwriters to continue to employ existing practices to stabilize a distribution of securities, which stabilization promotes confidence among issuers, selling security holders, and investors and further supports capital formation.”).

¹¹⁸ See *id.*

¹¹⁹ The Agencies requested comment on this topic in Question Nos. 64 and 65.

¹²⁰ The Agencies requested comment on this topic in Question Nos. 69 and 71.

¹²¹ The Agencies requested comment on this topic in Question No. 72.

necessary to eliminate uncertainty about the permissibility of syndicate activities that are ancillary to underwritten offerings and that reduce price volatility and facilitate an orderly aftermarket.¹²²

- **Sources of revenues:** “Customer revenues” in the underwriting context should include revenues attributable to syndicate activities, hedging activities and profits and losses from sales of residual positions as long as the underwriter has been making a reasonable effort to dispose of the residual positions in light of existing market conditions.¹²³

We illustrate these issues with examples below.

1. *The definition of “distribution” for purposes of the Volcker Rule should include all primary issuances.*

The Proposed Rule provides an exemption for underwriting activities if a banking entity satisfies seven criteria. One is that the underwriting transaction be effected “solely in connection with a distribution of securities for which the covered banking entity is acting as underwriter,” as defined using definitions from the SEC’s Regulation M.

The Proposed Rule uses the SEC’s definition of “distribution” under Regulation M,¹²⁴ which has a specific, limited meaning and is typically construed to be narrower than the Preamble to the Proposed Rule’s description of private placements and other transactions that are intended to remain permissible.¹²⁵ Capital raising and financing transactions that may not qualify as “distributions” under Regulation M include commercial paper issuances, issuer “dribble out” programs and small private offerings. These types of offerings involve the purchase of securities directly from an issuer with a view toward resale, but may not always be clearly distinguished by “special selling efforts and selling methods” or by “magnitude.” For instance, a commercial paper issuance might not involve road shows or the delivery of prospectuses (or other indicia of “special selling efforts”), and a small private placement may not meet the “magnitude” standard.¹²⁶

If uncertainty about the scope of a “distribution” were to deter underwriters from participating in these types of offerings, it would limit issuers’ access to capital, particularly via commercial paper and other short-term debt markets.¹²⁷ This result is not compelled by the statutory language and would make no corresponding contribution to financial stability. In view of the importance of issuers having unfettered

¹²² We discuss examples of these syndicate activities in Section I.B.2.

¹²³ The Agencies requested comment on this topic in Question No. 74.

¹²⁴ Under Regulation M, “distribution” means “an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.” 17 C.F.R. § 242.100(b).

¹²⁵ The Agencies requested comment on this topic in Question No. 77.

¹²⁶ Although we recognize that the Preamble to the Proposed Rule indicates that the “magnitude” requirement “does not preclude small offerings or private placements from qualifying for the underwriting exemption” (NPR at 68867), we believe this interpretation may be inconsistent with traditional analysis of whether an offering constitutes a “distribution” for purposes of Regulation M.

¹²⁷ The Agencies requested comment on this topic in Question No. 67.

access to capital markets, especially the short-term debt markets, the final rule should expand the underwriting exemption to be available for both Regulation M “distributions” and any primary issuance.¹²⁸

2. *Underwriting-related syndicate activities should more clearly be permitted.*¹²⁹

Regulation M applies not only to “underwriters” as defined, but also to other “distribution participants,” including prospective underwriters, brokers, dealers and other persons that are participating or have agreed to participate in the distribution.¹³⁰ This is in recognition of the key roles that such distribution participants play in the underwriting process. By limiting the Volcker Rule exemption for underwriting activities strictly to “underwriters,” the Proposed Rule would exclude dealers that do not deal directly with the issuer or selling securityholder (as might often occur, for example, in the case of selling dealer groups). We suggest that the final rule follow Regulation M’s definition of “distribution participant” and provide that a Volcker Rule “underwriter” include “a person who has agreed to participate or is participating in the distribution.”¹³¹

Furthermore, under the Proposed Rule, a permitted underwriting activity must be “solely in connection with a distribution of securities,” and the banking entity engaging in the activity must be acting as an underwriter in the distribution.¹³² This “solely in connection” standard extends beyond what the statute requires and could potentially exclude a number of customary underwriting syndicate activities that are traditionally undertaken to support the success of a distribution, mitigate risk to issuers and investors (and to the underwriters themselves) and facilitate an orderly aftermarket.

Companies raising capital typically consider derivatives strategies to be an integral part of the overall decision to pursue a transaction, and they expect underwriters to offer these strategies as a part of providing access to capital markets. Underwriters also traditionally purchase and sell in the market to hedge their exposure to those derivatives.¹³³ These are examples of practices that should fall under the

¹²⁸ Our proposal would include the resale of notes or other debt securities received by a banking entity from a borrower to replace or refinance a bridge loan. This treatment of securities received in connection with a bridge loan would preserve the ability of banking entities to extend credit and offer their customers a range of financing options; would be consistent with the exclusion of loans from the coverage of the Proposed Rule (Section __.3(b)(3)(ii) of the Proposed Rule); and would be consistent with our proposed “debt previously contracted” exception discussed in Section III.E.

¹²⁹ The Agencies requested comment on this topic in Question No. 76.

¹³⁰ Under Regulation M, “underwriter” means “a person who has agreed with an issuer or selling security holder: (1) [t]o purchase securities for distribution; or (2) [t]o distribute securities for or on behalf of such issuer or selling security holder; or (3) [t]o manage or supervise a distribution of securities for or on behalf of such issuer or selling security holder”; and “distribution participant” means “an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution.” 17 C.F.R. § 242.100(b).

¹³¹ The Proposed Rule includes in the definition of “underwriter” a person that has not dealt directly with the issuer, but has an “agreement” with another person that has. Section __.4(a)(4)(ii) of the Proposed Rule. This definition is less inclusive than it may have been intended to be. Individual selling dealers or dealer groups may or may not have written agreements with an underwriter in privity of contract with the issuer.

¹³² *Id.* at Section __.4(a)(2)(iii).

¹³³ Underwriters may also engage in purchasing and selling in the market to create or close out short positions in connection with an overallotment option (or in connection with other stabilization activities).

heading of “legitimate forms of underwriting in which market participants currently engage” and “existing practices to stabilize a distribution of securities” (which the Proposed Rule indicates should be permitted to continue¹³⁴), and are in connection with a distribution of securities, but could be difficult to evaluate under the ambiguous “solely in connection” standard. Accordingly, the final rule should omit “solely” from the “in connection with” criterion.

We also believe that the “solely” criterion could reduce innovation in the capital-raising process by casting doubt on new capital-raising methods that may develop. A number of derivatives-related strategies to raise capital were unknown a decade ago, but have since helped issuers to raise capital in cost-efficient transactions. We do not believe that the Volcker Rule was intended to reduce innovation in, or the competitiveness of, U.S. capital markets.

As the following examples show, underwriting syndicate activities include a variety of derivative strategies to help issuers raise capital, including, in some cases, by helping underwriters to hedge their own exposures that arise out of underwriting transactions.

Example 6: options in conjunction with underwriting-related syndicate activities can prevent dilution to shareholders. A convertible debt offering risks diluting the issuer’s existing shareholders when the debt is converted. To mitigate the impact of this dilution, the issuer may enter into “call spread” options. In this case, underwriters provide the issuer with an option to purchase, from the underwriters, the number of its own shares into which the debt would convert, at the price at which it would be convertible. As a result, if the debt does convert, the issuer will exercise the option and purchase the shares so that there is no net dilution.

To reduce the cost of this option, the issuer will often provide the underwriters with a warrant to purchase the same number of shares of the issuer’s stock at price that is higher than the option exercise price. Even if it is exercised, the warrant causes less net dilution than the convertible debt alone would have caused (because the warrant is typically net share settled, meaning that shares are issued only to the extent that shares underlying the warrant exceed the warrant’s total exercise price). Overall, the “call spread” arrangement may make a wider range of financing options feasible for the issuer of the convertible debt. This can help it to raise more capital at more attractive prices than if, because of ambiguity about what constitutes “solely” in connection with an underwriting, the underwriters could not conclude that they were permitted to enter into the call spread and related warrant.

Example 7: risk-mitigating activities support underwritings and help financial institutions raise capital. A financial institution seeking to raise capital may do so through a rights offering, in which existing shareholders receive rights to buy additional shares of stock at a specified price. Often, to ensure the success of the rights offering and the receipt of all possible proceeds, the underwriters will commit in advance to exercise any rights that are not exercised by shareholders. This is similar to underwriting of a stock offering: the issuer gains certainty about the amount of capital that it will raise, while the underwriters assume the risk of holding the position in the issuer’s stock if demand for the

¹³⁴ NPR at 68925.

offering proves to be insufficient.

To hedge their exposure to the issuer's stock (effectively a long position), the underwriters may sell the rights or the issuer's stock short while the rights offering is pending. The underwriters may also, as a means of covering such short sales, purchase from shareholders (and subsequently exercise) rights that were previously issued (but not yet exercised) in the rights offering and sell the shares of stock received upon exercise into the market. If the underwriters could not engage in these risk-mitigating activities, they would be less willing to underwrite the rights offering and would charge a higher discount to the issuer to compensate for their higher level of risk.

Example 8: a dealer's risk-mitigating hedging can help a customer to finance a transaction with regulatory uncertainty. A customer seeking to finance an acquisition that is subject to a lengthy regulatory approval process may issue securities to finance the acquisition through a forward contract with an underwriter, which will be settled after the approval is received. The use of the forward contract permits the customer to lock in its financing for the acquisition and limit the dilution to its shareholders until the acquisition is completed. The underwriter in this case would hedge its own exposure by borrowing securities from third-party lenders and then selling them short pending the settlement of the forward contract.

3. *"Customer revenues" in an underwriting transaction should include revenues from syndicate activities, hedging activities and profits and losses on the disposition of residual positions.*¹³⁵

Under the Proposed Rule, like permitted market making-related activities, permitted underwriting activities must be "designed to generate revenues primarily from fees, commissions, underwriting spreads or other income not attributable to . . . [a]ppreciation in the value of covered financial positions. . . or. . . [t]he hedging of covered financial positions."¹³⁶ As we noted above, underwriters will typically hedge positions that they take as part of underwriting and associated stabilizing activities. Because these hedging activities are undertaken to ensure that underwriters can manage risk while they help issuers and selling securityholders to raise capital and support an orderly aftermarket, revenue in connection with these hedging activities should be included in permitted "customer revenues," like fees, commissions and underwriting spreads.

Furthermore, although the Proposed Rule provides helpful flexibility on an underwriter's ability to dispose of any residual positions over time,¹³⁷ the final rule should go further to ensure that it does not inadvertently provide a disincentive for an underwriter to end up with a residual position. Specifically, so long as an underwriter continues to take reasonable steps to attempt to dispose of a residual position in light of existing market conditions, holding the residual position should be considered underwriting-related

¹³⁵ The Agencies requested comment on this topic in Question No. 74.

¹³⁶ Section __.4(a)(2)(vi) of the Proposed Rule.

¹³⁷ NPR at 68867 ("There may be circumstances in which an underwriter would hold securities that it could not sell in the distribution for investment purposes. If the acquisition of such unsold securities were in connection with the underwriting pursuant to the permitted underwriting activities exemption, the underwriter would also be able to dispose of such securities at a later time.").

and any revenues from the disposal should be counted as “customer revenues,” not income from “[a]ppreciation in the value of covered financial positions.” Residual positions are an inherent risk of many underwritten offerings, including, but not limited to, underwritten rights offerings such as the one described in Example 7 of Section I.B.2.¹³⁸ If their treatment under the final rule is negative or unclear, and does not address the revenues issue that we have noted, underwriters may be incentivized to underwrite smaller offerings at lower market prices or higher underwriter discounts because they will become averse to the risk of holding a residual position that may lead the transaction to be deemed impermissible under the Volcker Rule.¹³⁹

C. Permitted Hedging Activities

As the FSOC Study recognized, “[p]rudent risk management is at the core of both institution-specific safety and soundness, as well as macroprudential and financial stability. . . [t]he Volcker Rule should not be applied in a way that interferes with a banking entity’s ability to use risk-mitigating hedging.”¹⁴⁰ The statutory requirement that permitted hedging be “designed to reduce. . . specific risks” indicates a concern that what is generically called a hedge, particularly a short or derivative position, could actually represent prohibited proprietary trading. The Proposed Rule goes much further than even this, however, by adding two key additional requirements that go beyond the statutory requirement, that may not be meaningful or achievable in practice and that may well interfere with banking entities’ ability to engage in risk-mitigating hedging:¹⁴¹

- **“Significant exposures”**: The Proposed Rule requires that a permitted hedging transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction. This is rarely possible even for hedges that greatly reduce a banking entity’s overall risk, which we believe should be the ultimate requirement for permitted hedging.
- **“Reasonable correlation”**: The requirement that a hedging position be “reasonably correlated” to the position hedged arises from an unrealistically narrow view of hedging and distracts from a more appropriate focus on the reduction of overall risk.¹⁴² Prudent risk management requires that banking entities have flexibility to hedge on a dynamic and portfolio basis, and to hedge across asset classes when doing so provides the most effective reduction of overall risk. The “reasonable correlation” requirement could interfere with that.

¹³⁸ The Agencies requested comment on this topic in Question No. 79.

¹³⁹ The Agencies requested comment on this topic in Question Nos. 68 and 358.

¹⁴⁰ FSOC Study at 21.

¹⁴¹ Sections __.5(b)(2)(iii)-(iv) of the Proposed Rule. The Agencies requested comment on this topic in Question No. 102.

¹⁴² The Agencies requested comment on this topic in Question No. 103. We further note that “correlation” is a technical statistical term, quantifying the dependence among two variables based on a backward-looking historical data set. In this setting, it would not—at least without an express clarification to the contrary—have the colloquial sense of “related” or “likely to move together in the future.” Hence this requirement may be more limiting than the Agencies intended it to be.

If banking entities cannot use legitimately risk-mitigating hedging strategies, there are two likely outcomes, both undesirable. First, banking entities may step back from assuming risk on behalf of their customers, forcing those customers to retain risks even if they are less capable of managing them effectively. This would likely be bad for the company and, on a larger scale, for the broader economy. Alternatively, the banking entities may assume the risks but then find themselves forced to hold them because they cannot effectively hedge these risks.¹⁴³ This would not contribute to safety and soundness. To prevent these negative outcomes, the final rule should remove the “significant exposures” and “reasonable correlation” requirements, and instead focus on quantitative trading metrics such as VaR and the hedging policies and procedures that are required under the Proposed Rule’s compliance standards.¹⁴⁴ These policies and procedures will include information such as the asset classes that are available to be used as hedges and will be subject to review by regulators. This will allow regulators to gain sufficient information about the banking entity’s range of hedging strategies to make an informed judgment as to the reasonableness of those strategies.

Because both the “significant exposures” and “reasonable correlation” requirements of the Proposed Rule often raise similar concerns when applied to real-world hedging examples, we discuss several such examples separately in Section I.C.3.

1. Hedging is intended to mitigate risk, not prevent any new “significant exposures.”

The “significant exposures” requirement, which goes beyond the statutory language that permits hedging activities that are designed to mitigate “specific risks,” raises both a technical issue and a more fundamental issue that goes to the nature of hedging and the fact that “perfect” hedges are unavailable in most circumstances.

The technical issue is that, although the Preamble to the Proposed Rule acknowledges that almost all hedges will give rise to basis risk and counterparty risk,¹⁴⁵ the text of the Proposed Rule does not reflect that acknowledgment.

More fundamentally, the requirement that a hedging transaction not give rise to new significant exposures is incompatible with a wide variety of hedging transactions that banking entities use to reduce risk and operate in a safe and sound manner. If an asset is liquid enough and traded in a high enough volume, it may be possible to construct a hedge of one position in the asset with another position in the asset (or a synthetic position) such that the banking entity will have a very low “delta” (or exposure to

¹⁴³ The Agencies requested comment on this topic in Question Nos. 105 and 351.

¹⁴⁴ See Appendix C of the Proposed Rule.

¹⁴⁵ NPR at 68876 (“[T]he proposal also recognizes that any hedging transaction will inevitably give rise to certain types of new risk, such as counterparty credit risk or basis risk reflecting the differences between the hedge position and the related position. . . .”). “Basis risk” is, broadly speaking, the risk that two positions that are intended as a hedge perform in such a way that they do not in fact offset each other to the extent that was originally contemplated.

changes in the price of the asset). Like other banking entities, we use this type of hedging in many of our trading businesses when it is possible to do so.¹⁴⁶

However, most hedging scenarios are more complicated. As a general principle, hedging an illiquid position will almost always result in an imperfect hedge, because it was already determined that there was not ready demand for the position in the first place. Some hedges, such as those in the examples below, may require using positions in different maturities, different instruments or different asset classes altogether. This is consistent with the FSOC Study's observation that "[i]n executing principal transactions for which there is no natural subsequent buyer of the financial instrument, market makers will often hold the instrument in their portfolio but then hedge it using correlated instruments that they sell to other customers."¹⁴⁷ Many of these hedges might not, on their face, satisfy a requirement of no new "significant exposures" as a result of the hedge. Yet they may very well greatly reduce the "specific risks" of the original position, as measured by VaR or other risk-related metrics, have little or no potential for "hiding" proprietary trading and be advisable by any reasonable standard of prudent risk management and promotion of safety and soundness of the banking system. Accordingly, we suggest eliminating the "significant exposures" requirement as a qualitative standard. Regulators should instead rely on quantitative trading metrics and hedging policies and procedures to evaluate whether hedging activities are consistent with the statutory requirement of being "designed to reduce. . . specific risks."

2. *"Reasonably correlated" is inappropriate as a standard for permitted hedging under the Volcker Rule.*¹⁴⁸

Under the Proposed Rule, a permitted hedging transaction must be "reasonably correlated" to the risk or risks that the transaction is intended to hedge.¹⁴⁹ This is inappropriate as a uniformly applicable requirement for several reasons. Most fundamentally, correlation is essentially a retrospective concept. Although the Preamble to the Proposed Rule notes that "reasonable" correlation of hedging positions will vary,¹⁵⁰ it may still prove difficult or impossible to measure prospectively. Historical correlations will often be relevant, but cannot be dispositive, since markets and correlations can and do change. Furthermore, correlations are not guaranteed to be present at the outset of a hedge and may not actually materialize at any particular time during the hedge's life. Neither of these facts necessarily diminishes the prudence of the hedge as a risk-management tool. This is particularly true for "scenario" hedges, in which the hedging position is most correlated with the risks of the underlying position during times of large market moves or adverse changes in macroeconomic conditions.¹⁵¹ If the risks of the underlying position deteriorate during these times as well, then the hedge may be particularly effective and cost-efficient, regardless of whether

¹⁴⁶ Even in this comparatively simple case, however, the hedging position could potentially expose the banking entity to risks from volatility, interest rates or the passage of time, among other things, that were theoretically not present in the original position. Again, for even the most straightforward hedges, a requirement of no new "significant exposures" will often be unrealistic (or cause undue uncertainty about the permissibility of the hedge).

¹⁴⁷ FSOC Study at 23.

¹⁴⁸ The Agencies requested comment on this topic in Question Nos. 107 and 110.

¹⁴⁹ Section __.5(b)(2)(iii) of the Proposed Rule.

¹⁵⁰ NPR at 68875.

¹⁵¹ We give examples of such "scenario" hedges below.

the positions are well correlated at other times. From a risk-management standpoint, historical correlations are, in general, not a good substitute for management's best judgment as to the hedging positions that are likely to be most effective in reducing risk going forward, which could be informed by other factors such as implied volatility or the positions' behavior under simulated stress tests.

The "reasonable correlation" requirement should be removed from the final rule in favor of a more appropriate focus on quantitative trading metrics such as VaR and Risk Factor Sensitivities.¹⁵² If the Agencies retain this test in the final rule, at a minimum, it is critical that the final rule make clear that it should be given an expansive interpretation and will not require demonstrable correlation between positions at the outset of a hedge.

A banking entity's hedging mandates will provide a better and more natural opportunity for regulators to supervise hedging activities. These mandates will permit certain types of hedges and prohibit others (or require case-by-case approval) because experience and the dynamics of the relevant markets will have shown what the most effective hedges tend to be, even if they are positions in different asset classes or otherwise not perfectly matched to the underlying positions. Regulators will be able to confirm that the mandates are reasonable and provide appropriate controls on permitted hedging.

3. *Examples of hedging transactions that should be permitted, but might not satisfy the "significant exposures" and "reasonable correlation" requirements of the Proposed Rule.*

Banking entities use many trading strategies to hedge risks. In general, these strategies require balancing the degree to which a hedge reduces the risk from the underlying position with the costs, efficiency and availability of the hedge and other practical considerations, which can vary widely depending on market conditions.

Suppose, for example, that a banking entity holds a technology stock in inventory. From the perspective of risk reduction, the best "hedge" of all would simply be to sell the stock. The stock may be relatively illiquid (or, even if liquid, may not support liquidation of the position without an impact on the market), or the banking entity may prefer to keep it in inventory (to better serve customers who may wish to purchase it). In those cases, the banking entity could potentially sell a different technology stock short, or construct a hedging strategy based on options on one or more stocks or stock indexes. Some approaches may be more attractive than others depending on the prices and depth of the market for the various stocks and options and the banking entity's expected inventory needs. Even these comparatively simple hedging strategies could raise questions under the narrow "significant exposures" and "reasonable correlation" requirements.¹⁵³

¹⁵² The Agencies requested comment on this topic in Question No. 106.

¹⁵³ Furthermore, hedges within the same asset class, while conceptually among the simplest, may take place alongside a trading unit's customer flow trading and inventory management in that asset class, which could frequently raise the question of exactly which positions are "hedges." If the trading unit's risk profile and hedging activities are evaluated by reference to quantitative trading metrics such as VaR and hedging policies and procedures, as we suggest, this is not necessarily an issue. It could be problematic, however, if a banking entity were forced to identify and "tag" each transaction as a hedge for purposes of the "significant exposures" and "reasonable correlation" analysis.

As part of market making-related activity, banking entities often transact with customers to help customers hedge their own risks. In many cases, no direct hedge against the initial transaction will be available to the banking entity because the customer's transaction may have had customized terms or been done with respect to a less commonly traded position. In such a case, the banking entity may manage its own exposure by constructing a hedge with a more commonly traded (but distinct) position in the same or a similar asset class. This type of hedging is also likely to occur in the context of portfolio hedging of risks across a portfolio of positions, such as commodities derivatives. Although the Preamble to the Proposed Rule cites portfolio-level hedging as an activity that should be permitted,¹⁵⁴ the requirement of both no new "significant exposures" and "reasonable correlation" would, in many cases, create unnecessary ambiguity about the types of portfolio hedging that would be permissible.¹⁵⁵ Unnecessarily limiting the availability of hedging strategies, most of which will naturally be "imperfect" but may also legitimately reduce specific risks, would serve no policy goal and should be avoided in the final rule.

¹⁵⁴ NPR at 68875. The Agencies requested comment on this topic in Question Nos. 104, 107, 109 and 111.

¹⁵⁵ This is particularly true in the case of portfolio hedging of "diverse holdings" (as compared to, for example, hedging of the net exposure of a portfolio of numerous identical long and short derivative positions), which is what is contemplated by the Preamble to the Proposed Rule. *Id.*

Example 9: rare customer derivative transactions can be hedged with more common derivatives. An oil refiner might ask a market maker to provide refining margin swaps to hedge against the narrowing of the margin between the crude oil inputs that it purchases and the refined oil outputs that it sells. Under these swaps, the refiner would, on a designated schedule, pay the market maker the floating price of certain refined oil outputs, and the market maker would pay the refiner the floating price of certain crude oil inputs plus the pre-agreed margin. This insulates the refiner from a narrowing in margins, although it also limits the refiner's upside if margins widen instead. That exposure is transferred to the market maker as the counterparty to the swaps. For the refiner, the effect of the swaps would generally be to lock in a certain profit margin and put the refiner in a position to safely project its future earnings. This could be critical if, for example, the refiner were also trying to expand its operations or invest in a new business. In this way, the refining margin swaps market can contribute to the formation of capital and therefore to economic growth generally.

In this example, the oil refiner is a seller (of the refined oil that it produces). As the seller's counterparty under the swaps, the market maker takes on the economic risk of a buyer who has agreed in advance to buy at a price that may be higher or lower than the market price when the purchase occurs. To trade out of this risk, the market maker might, ideally, look to customers who are actual buyers of refined oil products and want to hedge the price of the products that they must purchase to run their businesses. But there may not be demand for the exact swaps that the market maker exchanged with the refiner: the swaps could be with respect to a less commonly traded grade of oil, for example, or they could be longer-dated than the corresponding swaps most commonly demanded by buyers

Accordingly, the market maker might manage its risk from the refiner's swaps by dynamically hedging with swaps (or options or other derivatives) in which it would find greater liquidity. In this example the market maker would probably evaluate the risk it has from the refiner's swaps not in isolation, but rather in the context of its portfolio of commodity swaps, with a view toward cost-effectively managing "open" risk across the portfolio.

The market maker might have several means of demonstrating that its portfolio is, on the whole, much less risky than if it had not engaged in the type of dynamic portfolio hedging described. The portfolio's VaR metrics, for example, might show that the market maker is much less likely to suffer severe losses from its commodity swaps positions. It is unclear whether this hedging approach would clearly be permitted by the Proposed Rule in light of the "significant exposures" and the "reasonable correlation" requirements. When the market maker hedges exposure under the refiner's swaps to the price of one type of oil with (short) exposure to the price of another type of oil, it expects that the two prices will move predictably against each other to an extent that justifies the hedge and reduces overall risk. It has, however, now introduced a risk—exposure to the price of the second type of oil—that was not originally present in the refiner's swaps. Furthermore, the two prices may not always be correlated; for instance, a decrease in supply of one of the oils could affect its price but not the price of the other oil. If the hedging swaps are shorter-dated than the refiner's swaps, they would also be subject to factors that affect near-term prices more than long-term prices.

Banking entities also often hedge one position (or positions) with a position in a different asset class entirely. This may be because there is little liquidity or cost-ineffective pricing (or both) for a hedging position in the same asset class. Furthermore, correlation that emerges between the asset classes in

stressed markets or upon certain changes in macroeconomic conditions may offer the best protection against the worst risks associated with the original position. As a result, as we noted above, these “scenario” hedges may show significant correlation only upon large movements in prices or macroeconomic conditions, and not otherwise—yet this may be precisely what makes the hedges especially valuable as risk-management tools.

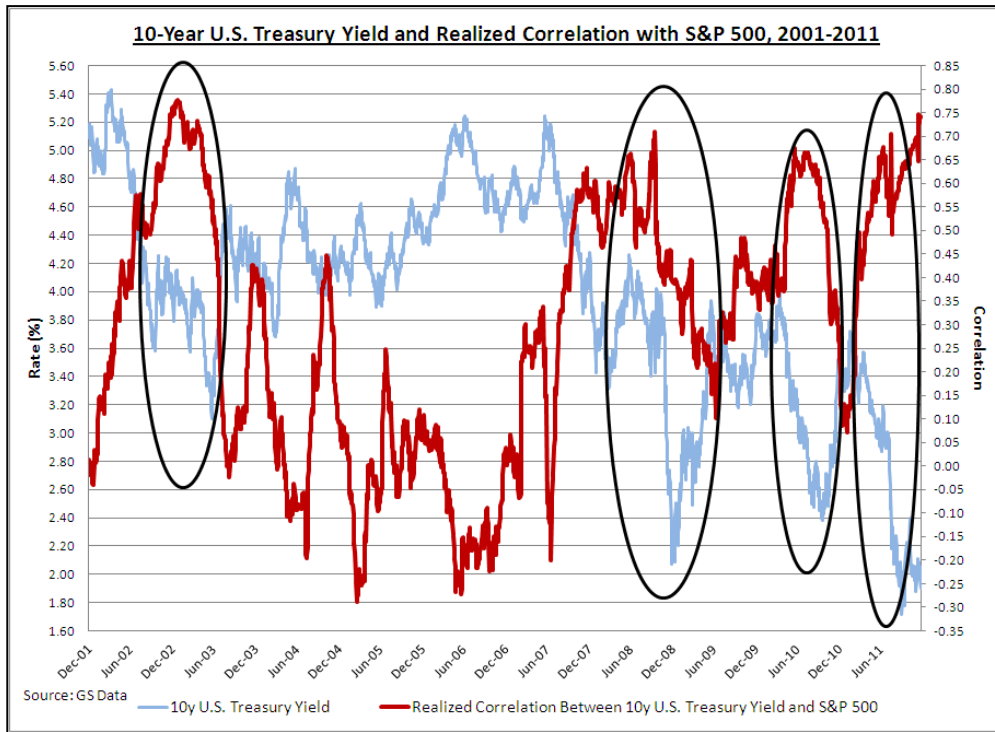
Example 10: different asset classes can be the most effective hedge for municipal bonds.

Hedging the credit risk in municipal bonds poses significant challenges to dealers. Because the bonds are often difficult to borrow (they are often relatively illiquid and furthermore lenders may suffer negative tax consequences), a dealer usually cannot “short” the bonds, which effectively forces the dealer to hedge in a different asset class. In some cases, the best, most risk-reducing hedge of a long position in municipal bonds, which a banking entity could acquire as part of its market making-related activities, may be a single-name corporate credit default swap (CDS) on obligations of companies that face similar risks to those of the relevant municipal issuer. For example, a dealer that has acquired bonds of a state or local power generation or distribution cooperative might choose to hedge the credit risk of those bonds by buying a single-name corporate CDS on the obligations of investor-owned utilities that face similar business risks to those of the cooperative. This may be particularly true when there is not a liquid market in the municipal bonds themselves, but when the banking entity’s internal models, or management’s best judgment based on experience, suggests that large declines in the value of the bonds would likely be accompanied by widening of credit spreads and an increase in the value of the CDS, which would offset a portion of the decline in value of the bonds. As in the prior example, this hedge reduces the banking entity’s risk, but could be considered under the Proposed Rule to introduce a new “significant exposure” to the CDS or not to be “reasonably correlated.”

Example 11: different asset classes can be the most effective hedge for interest rate risk.

Customers such as life insurance companies (which have long-term liabilities, but predominantly shorter-term assets) may wish to protect themselves against declines in interest rates. To do so, they may purchase call options on U.S. Treasuries from a market maker. To mitigate its risk under these options, the banking entity could seek a corresponding hedge in the U.S. Treasury options market, but there might be poor liquidity for a relatively large position in such an option or the option might otherwise be cost-ineffective. Instead, the banking entity might be able to more effectively hedge with put options on the S&P 500, which tends to decline when U.S. Treasury yields decline.

To illustrate this example, the following chart shows, for approximately the past 10 years, the yield on 10-year U.S. Treasury notes and the realized correlation between that yield and the S&P 500 (note that it does not show the actual price level of the S&P 500):



The circled regions of the chart show that correlation between the 10-year Treasury yield and the S&P 500 was highest in periods when yields were declining. When Treasury yields are declining, prices of Treasuries are rising; hence it is more likely that the customer's call options purchased from the market maker would become exercisable (or "in the money"). This exposes the market maker to the risk of losses from having to sell U.S. Treasuries to the customer at a price lower than the price it would have to pay to buy them. To hedge this risk, as we noted above, the market maker might purchase S&P 500 put options. This hedging strategy may be attractive because the exposure to U.S. Treasury yields from the call option is in the opposite direction from the S&P 500 put options.

On the other hand, as the chart shows, in periods when 10-year Treasury yields were not declining, the correlation between those yields and the S&P 500 was typically not nearly as high (and was in fact sometimes negative). If a market maker enters into this hedge in a period during which Treasury yields are not declining (to nevertheless protect itself from the risk of a period of declining yields), it does so with no assurance that the high correlation will be realized at any particular point during the life of the hedge, potentially complicating efforts to measure "reasonable correlation" on an ongoing basis. If the market maker could not use this "scenario" hedging strategy, it might have to either decline the life insurer customer's request to purchase the U.S. Treasury call options, or quote the customer a higher price for the options.

Example 12: different asset classes can be the most effective hedge for a real estate securitization. As part of a customer transaction, a market maker might take into inventory assets such as a securitization of a real estate acquisition financing. The market maker will try to hedge the exposure to this position. However, there is no "natural" hedge for the securitization. The market maker could hedge it with an index of commercial mortgage-backed securities such as the CMBX, but this index itself may be too illiquid to support a hedge in the necessary size. Moreover, the correlation

between the securitization position and the CMBX may in fact be relatively low.

The market maker may be able to find a hedge with a higher correlation in a more liquid market—in other words, a hedge that is both more effective and less expensive—by using a mix of other instruments, such as high-yield corporate debt, CDSs of firms in the same industry and S&P 500 options. Yet this composite hedge raises the same issues that we have noted under the “significant exposures” and even the “reasonable correlation” requirements (especially if the hedging positions are considered individually and not together).

II. ADDITIONAL COMMENTS ON THE PROPOSED RULE’S REQUIRED COMPLIANCE REGIME AND QUANTITATIVE TRADING METRICS¹⁵⁶

To design an effective compliance regime around measurement and monitoring of the quantitative trading metrics, the final rule should provide a less granular definition of “trading unit” and significantly de-emphasize the prospect of trade-by-trade analysis of permitted activities. These points have important implications for the operational feasibility of the compliance regime and the expense required to develop and maintain it. It will also have important implications for trader psychology and trader willingness to make proper and deep markets and take appropriate risk to facilitate customer transactions. We discuss these and other topics related to the required compliance regime and quantitative trading metrics in Sections II.A through II.C.

A. The definition of “trading unit” should be less granular—both because better data will be obtained that way and because it is critical for keeping the costs and logistical challenges of the compliance program at a manageable level.¹⁵⁷

We agree with the Agencies that calculating quantitative trading metrics for an individual trading desk—especially if a small number of trades are analyzed in isolation—will likely produce “noise,” result in many false positives and often not provide any readily apparent interpretation or characterization of the underlying trading activity, while nonetheless imposing a significant compliance burden on the banking entity.¹⁵⁸ The Proposed Rule’s approach to these issues—defining “trading unit” to include the desk level, the firmwide level and several intermediate levels—would present an enormous challenge for any banking entity with significant trading operations.¹⁵⁹

¹⁵⁶ The Agencies requested comment on this topic in Question Nos. 1-4.

¹⁵⁷ The Agencies requested comment on this topic in Question No. 157.

¹⁵⁸ NPR at 68885 (“[A]pplying a quantitative measurement to a trading unit at a highly granular level could, if it captured only a narrow portion of activity that is conducted as part of a broader business strategy, introduce meaningless ‘noise’ into the measure or result in a measurement that is idiosyncratic in nature. This highly granular application could render the measurement relatively uninformative because it would not accurately reflect the entirety of the trading activities being conducted.”).

¹⁵⁹ The Agencies requested comment on this topic in Question No. 160.

We strongly disagree with the Agencies' contention in the Preamble to the Proposed Rule that "there may be little, if any, incremental burden associated with calculating and reporting quantitative measurements at multiple levels."¹⁶⁰ This is important both as a computational matter and for managing the expense of designing and implementing compliance programs for more "trading units" than are necessary. For example, some metrics, such as VaR, are not simply additive and would require separate calculations at each level. Furthermore, even when a banking entity already calculates certain metrics today for risk management purposes, those metrics may be calculated by business-side risk managers and not reviewed or tested by an independent control function as may be required under the compliance program described in Appendix C of the Proposed Rule.¹⁶¹

The compliance program will be extensive. It will require banking entities to develop new technologies (such as, potentially, to document price quotes disseminated by a market making trading unit or other indicia of customer-facing activity, or to identify and analyze hedging transactions in more detail than in the past). Banking entities will also need to develop new policies and procedures for trading units (including new or updated trading and hedging mandates as necessary) and, in all likelihood, hire additional employees to review each metric for each trading unit and carry out the expanded compliance and internal control functions that the Volcker Rule will require. These costs would spiral if banking entities are deemed to have an inordinately large number of "trading units," which could be caused not only by an overly granular definition of "trading unit," but also by a requirement to calculate and report quantitative trading metrics and implement compliance regimes at multiple levels within a banking entity.

For these reasons, we believe it is more important by far—and more appropriate as both a theoretical and a practical matter—to find the single most appropriate level. Furthermore, we believe that going as low as the individual desk level generally will not be necessary to determine whether a business engages in prohibited proprietary trading, meaning that the many difficulties associated with calculating metrics and implementing comprehensive compliance programs at the desk level are not justified. On the contrary, there is likely to be a useful middle ground between "aggregat[ing] a variety of distinct trading activities," which the Preamble to the Proposed Rule indicates could obscure proprietary trading, and a "highly granular application" of metrics to individual desks or small groups of traders that could result in "meaningless 'noise.'"¹⁶²

In fact, to effectively interpret quantitative trading metrics and analyze the character of trading activities, it will frequently be necessary to look across one or more related desks or legal entities through which a banking entity conducts a coordinated trading strategy. For instance, a banking entity's market making-related activities with respect to credit trading might involve making a market in bonds (traded in a broker-dealer), single-name CDSs (in a security-based swap dealer) and CDS indexes (in a swap dealer). For regulatory or other reasons, these transactions could take place in different legal entities, but all of them should be considered part of a single trading unit in order to get a fair picture of the market making character or hedging strategies represented by the trading.¹⁶³

¹⁶⁰ NPR at 68885. The Agencies requested comment on this topic in Question Nos. 159 and 169.

¹⁶¹ The Agencies requested comment on this topic in Question No. 173.

¹⁶² NPR at 68885.

¹⁶³ As we discuss in Section III.B, it would be inefficient and counterproductive for trading units, which often span legal entities, to be subject to review by multiple regulators, each of which would see only those trading activities that
(footnote continued)

We do understand that problems with calculating quantitative trading metrics at the multi-desk level would potentially arise if desks of distinctly different trading profiles were grouped together. On the other hand, a banking entity will likely have expended considerable effort (in consultation with its regulator) to determine the appropriate level at which to calculate VaR and other risk limits, determine trading book size, budget profit and loss, assess capital usage, analyze compensation metrics (under guidance from its regulators) and operate its existing risk management processes. Existing levels utilized for these purposes typically reflect customer bases, the levels at which there is clear trading management accountability and authority to direct actions and the levels at which banking entities engage with their prudential regulators on safety and soundness risk metrics.

Calculating Volcker Rule quantitative trading metrics at the appropriate level for each trading unit will actually *help* identify meaningful trends, and outliers, more clearly than would be possible from a smaller sample size of trades at a level that is too granular to allow reasonable inferences (or, conversely, a sample size that is too large because it aggregates unrelated trading units).¹⁶⁴ In some cases, this process might, for example, produce a grouping of desks that trade structurally similar products in geographically different markets. In other cases, because of organization, management, customer bases or other factors, the reverse might be true. In any event, the Agencies should affirm that the smallest organizational unit will not automatically constitute its own trading unit, and that regulators will approach the question of trading units without a presumption to the contrary. This would preserve the necessary flexibility to define trading units in the way that proves to be the most sensible for each banking entity.¹⁶⁵

(footnote continued)

are conducted in the legal entity subject to its supervision, outside of the context of the broader trading or hedging strategy. For this reason, we strongly believe that a single regulator should be responsible for Volcker Rule compliance with respect to all entities within a banking entity's affiliate group. This would not only more accurately reflect a trading unit's activity, but would also provide regulators with a better way of preventing potential evasion that could occur if they only see "part of the picture."

¹⁶⁴ For example, a U.S. credit trading business might have traders who focus on making a market in bonds of issuers in a specific industry, such as "retail" companies like large department stores. The flow of customer trading in this sector may be higher in some periods and lower or even zero in other periods. To be able to facilitate these customer trades when they do come in, the traders would likely continue to maintain some inventory of these "retail" bonds. Accordingly, looking at these traders' Inventory Risk Turnover or customer-facing trade metrics in a vacuum, without incorporating their trading activities into the metrics for the broader U.S. credit trading business, could show a high degree of variance that would not reflect the fact that the traders have maintained a consistent, customer-oriented trading strategy to make a market in "retail" bonds. In this case, calculating metrics for U.S. credit trading as a whole would be much more viable as a means of understanding the market making character of the trading.

¹⁶⁵ Under our proposed approach, the determination of trading units would be a detailed, in-depth process, and the determinations of trading units would not be identical across banking entities. One result of this process would be the elimination of combinations of trading desks that are either too small or too large to be particularly helpful to consider as a trading unit, but that might have been required to be trading units under the Proposed Rule. We believe that focusing the analysis of trading units in this way will prove more effective in the long term.

B. “Trade-by-trade” analysis of permitted market making-related, underwriting and hedging activities is not practical and will impair market efficiency by making traders unduly uncertain about the permissibility of their activities.

Even within a properly defined “trading unit,” assessing market making-related activities down to the level of a “single significant transaction”¹⁶⁶ could create a number of problems that may not practically be solvable. As we discussed in Section I.A, market making by its nature cannot always be seen on a trade-by-trade basis, without consideration of the relevant trading unit’s business and the trades in which it engages over time. Focusing on a trade-by-trade analysis is likely to inhibit traders from making markets effectively, particularly during times of stress. We urge the Agencies to think carefully about the effects that trade-by-trade analysis would likely have on trader behavior and trader incentives to provide market making services.

Of course, individual traders will need to understand the Volcker Rule and comply with the policies and procedures that will result from it. On the other hand, it is not reasonable for traders to analyze each single trade or block of trades, in real time, for evidence of intrinsic market making character. The dilemma in this case, in its starkest form, is that a trader is unlikely to know in advance whether a particular trade will, by itself, be deemed to be a “single significant transaction” or “noise.” If traders perceive undue ambiguity in the requirements for their permitted market making activities, trading businesses may hew closer to an “agency-like” trading model and may be less willing to act as dealers and market makers. This would reduce liquidity and adversely affect pricing. For example, a trader might refuse to execute a customer sell order as principal for fear of building inventory that cannot be immediately resold, particularly in a rapidly declining market—which is precisely when market makers are most needed to provide liquidity.

Like other aspects of market making-related activities, the appropriate measurement period for each quantitative trading metric should be evaluated on a trading-unit-by-trading-unit basis to determine the appropriate extent to which transactions should be aggregated and analyzed together for market making or underwriting character. Accordingly, the final rule should remove the Proposed Rule’s general statement that trade-by-trade analysis may often be warranted.

C. Additional comments on quantitative trading metrics required under the Proposed Rule.

As we have emphasized throughout our letter, we believe quantitative trading metrics generally represent the best path toward a workable regulatory and compliance regime for the proprietary trading restrictions of the Volcker Rule. In this section of our letter we provide more detailed feedback on the five categories of quantitative trading metrics proposed in Appendix A of the Proposed Rule and identify the metrics that we believe have the most promise for distinguishing between prohibited proprietary trading and permitted activities.¹⁶⁷ We have classified the metrics into three categories:

¹⁶⁶ NPR at 68961 (“The particular types of trading activity [subject to analysis as market making-related activities] may involve the aggregate trading activities of a single trading unit, a significant number or series of transactions occurring at one or more trading units, or a single significant transaction, among other potential scenarios.”).

¹⁶⁷ The Agencies requested comment on this topic in Question Nos. 143, 146, 155, 165, 168, and 172.

- **“Indicative” metrics** that are most useful for distinguishing permitted activities from prohibited proprietary trading when taken as a whole. These are Fee Income and Expense, Spread P&L, Inventory Risk Turnover and the Customer-Facing Trade Ratio (provided that the last is defined appropriately to be based on risk rather than number of trades).
- **“Contextual” metrics** that could be helpful in context as a means of understanding a trading unit’s business and risk profile and the nature of the markets and asset classes in which it is active, but would not necessarily serve to identify prohibited proprietary trading (and would not be useful, by themselves, as triggers for further review of a particular trading unit’s compliance). These include most of the Risk-Management and Revenue-Relative-to-Risk Metrics, as we describe in more detail below.
- **Metrics that the Agencies should consider removing from the final rule**, because, in our view, they show less promise in their ability to identify prohibited proprietary trading, or the cost of their implementation would significantly outweigh the modest additional information that they would provide.¹⁶⁸ These are VaR Exceedance, Comprehensive P&L Attribution, Skewness of Portfolio P&L, Kurtosis of Portfolio P&L, Inventory Aging and Pay-to-Receive Spread Ratio.

1. *Risk-Management Metrics.* With the exception of VaR Exceedance, we consider these to be contextual metrics that would be appropriate to retain in the final rule. They generally would not provide a direct indication of prohibited proprietary trading (or the absence thereof). These measures are directly affected by the size of the trading unit and its portfolio of positions: for example, the VaR of a large portfolio with high levels of customer flow trading could be greater than that of a smaller, riskier portfolio just because of size. Furthermore, amounts such as VaR and Stressed VaR are highly variable across trading units and vary based on market conditions and the types of products traded.

On the other hand, most of the risk-management metrics could be helpful to orient regulators to a trading unit’s overall size and risk profile. With respect to Risk Factor Sensitivities and Risk and Position Limits, banking entities should be allowed to designate, in consultation with their regulators, the “core” data that will be reported for these metrics. For example, for Risk Factor Sensitivities, a trading unit might report key “greeks” such as delta, vega and gamma for relevant portfolios, but not necessarily less common higher-order greeks or other figures that tend to have more limited utility, even if they are sometimes calculated within the trading unit. This would ensure that the amount of data reported is manageable and interpretable both for regulators and for the banking entity’s internal control functions.

We suggest that the Agencies consider removing the VaR Exceedance metric. Its primary function is to analyze the quality of a banking entity’s modeling of VaR. VaR backtesting is already reported to regulators as part of the supervisory process and should not be duplicated in the Volcker Rule compliance regime. Furthermore, VaR Exceedance bears an extremely attenuated relationship to proprietary trading. As we noted, VaR itself is not particularly indicative of proprietary trading, and VaR Exceedance is a second-order metric that is too far removed from the substance of the underlying trading to be meaningful for Volcker Rule purposes.

¹⁶⁸ The Agencies requested comment on this topic in Question No. 170.

2. *Source-of-Revenue Metrics.* In general, market making businesses make money on fees, commissions and spreads, while these are expenses for proprietary businesses.¹⁶⁹ Accordingly, Fee Income and Expense and Spread P&L have the potential to be significant indicative metrics that may be used to help distinguish permitted activities from prohibited proprietary trading.

We note that, although these two metrics are described separately in the Proposed Rule, they should logically be considered together because they are both measures of customer revenues and, in practice, may function as substitutes for each other. For example, in certain commission-based equity trading businesses, a trading unit often loses money on the price of a customer trade (negative Spread P&L), but that loss may be more than offset by direct commissions from customers (positive Fee Income and Expense). In this case, looking only at Spread P&L would not reveal that the trading unit generally makes a profit on customer trades. We refer to the sum of Fee Income and Expense and Spread P&L as “New Trades P&L.”

The discussion in Appendix A of the Proposed Rule indicates that the Agencies understand that it will not always be clear how best to calculate Spread P&L.¹⁷⁰ This is certainly true, and we emphasize that it will indeed be critical for regulators to be flexible and work with banking entities to determine the appropriate proxies for spreads on an asset-class-by-asset-class and trading-unit-by-trading-unit basis.

Comprehensive P&L and Portfolio P&L are reasonable as contextual metrics, but as we have discussed throughout this letter, Portfolio P&L is not necessarily indicative of proprietary trading; rather, in many cases it is a necessary consequence of bona fide market making-related, underwriting and hedging activities.¹⁷¹

We suggest that the Agencies consider removing the Comprehensive P&L Attribution metric. Attributing revenues to risk factors across entire portfolios—which experience shifts in inventory and various effects from prices, volatilities, interest rates, credit spreads and numerous other factors—would be extremely difficult, if not impossible. It would be extremely burdensome to design and implement a method even to attempt to calculate this metric. Furthermore, it is not clear what relationship, if any, the metric would bear to proprietary trading. Accordingly, including this metric in the final rule would not be advisable given its high implementation costs and doubtful utility.

3. *Revenue-Relative-to-Risk Metrics.* We believe these are, for the most part, appropriate contextual metrics. We would suggest that New Trades P&L be substituted for Portfolio P&L for purposes of Volatility of P&L, P&L-to-Volatility Ratio and Unprofitable Trading Days metrics. New Trades P&L would make a better complement to Comprehensive P&L because it captures customer revenues more

¹⁶⁹ Note that this statement says nothing about whether market makers make *more* money from customer revenues *than from* price movements of inventories or about the proportion of trades in which market makers themselves pay fees, commissions or spreads. See the related discussion in Section I.A.6.

¹⁷⁰ NPR at 68958-59 (“For [some] asset classes in which a trading unit is engaged in market making-related activities, bid-ask or similar spreads may not be widely disseminated on a consistent basis or otherwise reasonably ascertainable.”). Even in liquid markets, bid-offer spreads may be available but valid only for certain trade sizes. It will therefore be critical for regulators to be open to the development of reasonably implementable proxies for Spread P&L, potentially including end-of-day spread proxies or related metrics, for liquid products as well as illiquid products.

¹⁷¹ See the related discussion in Section I.A.6.

completely and is therefore more useful for distinguishing market making businesses from proprietary trading businesses.

Furthermore, we suggest that the Agencies consider removing Skewness of Portfolio P&L and Kurtosis of Portfolio P&L, which our analysis suggests tend to produce inconsistent results within and across trading units and from which it will generally be difficult to draw any meaningful conclusions, even in context with other metrics. For example, a trading unit that had days of large gains and days of large losses in equal numbers could have negligible skew and moderate kurtosis, whereas a trading unit with consistent profitability but a single day of moderate losses could have a larger negative skew and a higher kurtosis. These higher-order measures are opaque and sensitive to idiosyncrasies in daily P&L. We believe the standard risk management metrics (VaR and Risk Factor Sensitivities) are a far more transparent and useful tool for assessing risk.

4. *Customer-Facing Activity Metrics.* As we noted above, an appropriately defined Customer-Facing Trade Ratio could be an important indicative metric. Because it requires a bottoms-up trade-by-trade analysis and additional infrastructure to mark each trade as a customer or non-customer facing trade, its calculation will be complex and data-intensive and will require significant resources to implement. Nonetheless, the Customer-Facing Trade Ratio may be helpful for distinguishing prohibited proprietary trading from market making because market makers have a mix of customer and dealer flows,¹⁷² whereas proprietary traders generally do not have “customers” as defined in Appendix A of the Proposed Rule.¹⁷³ There is one caveat, which is that sometimes dealers act as customers of other dealers, so it will be important to properly calibrate the definition of customer to maximize the benefit of this metric. As we explained in the Introduction, number of trades is not an appropriate basis for measurement because it does not reflect the size or risk of positions taken. A market maker could make one large purchase from a customer that it resells in several smaller transactions in the inter-dealer market, for example.

Instead, notional size or risk of trades would be a better basis. In the example just given, a notional-based or risk-based ratio would be close to 1, indicating that the market maker traded approximately as much with non-customers as with customers because that was the amount of trading that was necessary to lay off the risk from the customer trade. This approach would “tell the story” much more accurately than number of trades.

The Inventory Risk Turnover metric may also be a useful indicative metric in the case of liquid positions, since market making businesses with customer flows tend to trade in and out of positions more frequently than proprietary trading businesses. The final rule should clarify that Inventory Risk Turnover metrics will not be required to be calculated for every possible Risk Factor Sensitivity measurement for the applicable portfolio. Rather, a banking entity and its regulator should determine one or two core risk factors

¹⁷² For example, dealers may hedge or exit customer positions and engage in other inter-dealer trading. See the related discussion in Section I.A.1.

¹⁷³ “Specialist” market makers, who may also not have “customers,” represent an important exception to this principle, as we noted in Section I.A.3. Another argument for conferring a positive presumption on trading by registered market makers is that their trading activities might be difficult to evaluate using quantitative trading metrics designed for customer-facing market making businesses, but they nonetheless directly contribute to liquidity from which customers benefit and should not be discouraged from acting in that capacity.

per asset class with respect to which Inventory Risk Turnover will be calculated to strike a reasonable balance between the cost of calculation and the benefits provided by this metric.¹⁷⁴

In contrast, Inventory Risk Turnover would not be indicative for illiquid or difficult-to-hedge products, which naturally have lower risk turnover. Market makers dealing in illiquid products typically need to hold more inventory over longer periods of time, in some cases for years. For example, an interest rate swap that hedges a company's outstanding debt will typically have a maturity equal to that of the debt, which may be 10, 20 or 30 years. Banking entities should not, however, be penalized for entering into longer-dated trades to facilitate customer requests for risk reduction and certainty over longer periods of time.

Finally, we suggest that the Agencies consider removing the related Inventory Aging metric. It is generally not applicable to derivatives,¹⁷⁵ and for non-derivatives it provides essentially similar information to Inventory Risk Turnover in many cases.

5. *Pay-to-Receive Spread Ratio.* We suggest that the Agencies consider removing this metric. The Pay-to-Receive Spread Ratio would be just as costly to calculate as the Customer-Facing Trade Ratio (because it would also require trade-level analysis that banking entities would typically not otherwise undertake), but it would not provide additional insight beyond what could be gained from that metric plus Spread P&L. Spread P&L indicates whether a trading unit is, overall, receiving or paying spread revenues. The Customer-Facing Trade Ratio, of course, measures the extent to which a trading unit's trading is with customers. A Pay-to-Receive Spread Ratio would be unlikely to communicate anything that these two metrics together do not; its small marginal benefit does not outweigh its costs. Moreover, if, as we recommend in Section II.C.3, Unprofitable Trading Days is calculated by reference to New Trades P&L (rather than Portfolio P&L), this will give additional information about the number of trading days on which a trading unit's customer revenues are negative.

III. OTHER COMMENTS ON THE PROPOSED RULE

A. *Timing of Implementation and Requirements for the Conformance Period*

As drafted, the Proposed Rule would require a banking entity subject to the reporting, recordkeeping and compliance program requirements to begin furnishing reports—and to have developed and implemented the required compliance program for all trading units—as of July 21, 2012, and to cease all prohibited proprietary trading activities “as soon as practicable” thereafter.¹⁷⁶ We recognize that the statute requires the Volcker Rule to be effective as of that date and to be subject, unless extended by the Federal Reserve, to a two-year conformance period. On the other hand, accelerating full compliance with the Proposed Rule's considerable infrastructure requirements to the earliest possible date is neither required

¹⁷⁴ We believe that the marginal benefit of calculating Inventory Risk Turnover for non-core risk factors would be minimal and would not provide any additional insight into a trading unit's activities.

¹⁷⁵ The amount of time that a position has been in a trading unit's inventory may be relevant for non-derivatives, such as stock or bonds, because the trading unit generally sells the same instrument that it bought and therefore truly “turns over” the inventory. By contrast, many derivatives, such as swaps or long-term commodity supply contracts, represent a contractual relationship with the counterparty and are not, themselves, traded to other counterparties.

¹⁷⁶ NPR at 68855.

by the statute nor realistically feasible, especially given the timeline on which the final rule is likely to be issued.¹⁷⁷

Even once a final rule has been issued, developing, testing, implementing and providing robust internal controls for new systems to collect, monitor, analyze and output data for required reporting—in other words, the tasks that the Proposed Rule would require to be completed by July 2012—will be an extensive and time-consuming process.¹⁷⁸ Moreover, even when a banking entity already calculates certain quantitative trading metrics or other data that are close to what would be required under the Proposed Rule, it may not always do so with the documentation, internal controls and other policies and procedures applicable to information that banking entities formally submit to regulators in their supervisory capacities.

As we noted above, we recommend that the Federal Reserve's prior conformance rule be revised with respect to the proprietary trading provisions of the Volcker Rule to reflect a multi-stage implementation process. This could include stages such as dismantling any remaining dedicated "bright-line" proprietary trading units; creating policies, procedures and trading unit mandates; gradually rolling out a subset of metrics across trading units before implementing the full suite of metrics that are ultimately adopted; or rolling out metrics for one trading unit at a time.¹⁷⁹

Implementation and supervision may occur most efficiently and effectively through a "pilot" program in which certain designated trading units come into compliance on a more accelerated schedule than others. This process would still require banking entities to begin developing necessary infrastructure and to work continuously toward full compliance during relevant conformance periods. It would also allow banking entities and their regulators to get "hands-on" experience with the Volcker Rule and to address technological, logistical and other problems that may arise (many of which may be difficult to predict in advance) on a smaller and more controlled scale.¹⁸⁰

¹⁷⁷ These deadlines are not mandated by the Volcker Rule and do not follow the Congressional intent expressed in the Volcker Rule itself. First, Congress did not intend for July 21, 2012 to be the date by which banking entities must comply with the Volcker Rule. Instead, the statute provides for a two-year conformance period from July 2012 to July 2014, with up to three one-year extensions, and provides the Federal Reserve with extensive discretion to phase in the requirements of the Volcker Rule. Second, Congress intended to provide banking entities with at least nine months from the time the final rule is adopted until its requirements become effective to prepare for the beginning of the transition period. See Sections 13(b)(2)(A) and 13(c)(1) of the BHC Act. Furthermore, the Agencies requested comment on more than 1,300 questions in the Proposed Rule and are certain to receive a large number of comments on the Proposed Rule, to which we believe it will be critical to give full consideration given the sheer complexity of the Volcker Rule.

¹⁷⁸ The Agencies requested comment on this topic in Question Nos. 147 and 149.

¹⁷⁹ As we noted above, because of the sheer complexity of implementation, and number of competing concepts that must be reconciled and balances struck to design an effective final rule, the Agencies may also wish to consider re-proposing the Volcker Rule regulations.

¹⁸⁰ Again, we point to the implementation of TRACE by the Financial Industry Regulatory Authority ("FINRA") as a successful precedent for a gradual and deliberate implementation of a complex new regulatory requirement. TRACE generally requires prompt reporting of information about OTC transactions in fixed income instruments, which then becomes publicly available. Before TRACE could become fully effective, fixed income dealers had to both develop the infrastructure to report trade information and adjust to the effects that the availability of new information would have on trading in fixed income markets. TRACE was initially implemented in three phases over
(footnote continued)

B. Coordination Among Regulators

The Volcker Rule's prohibition on proprietary trading applies to any company that controls an insured depository institution and to all its affiliates and subsidiaries.¹⁸¹ Supervision of a banking entity's compliance with the prohibition will be complex, especially for banking entities with larger trading operations in multiple legal entities and jurisdictions. We expect that effective communication and a healthy flow of information between banking entities and their regulators will be critical to ensure efficient, high-quality supervision. This may be particularly true with respect to the quantitative trading metrics for a given trading unit within a banking entity, for which effective review and interpretation will require an understanding of the trading unit's business, products and customers.

As drafted, the Proposed Rule could subject a banking entity's trading activities to review by multiple regulators as a result of the number and diversification of the entities through which the banking entity conducts its businesses.¹⁸² Furthermore, the vast majority of trading units will span multiple legal entities because they may engage in trading in products that span different legal regimes, such as selling securities, hedging with interest rate swaps and hedging with foreign exchange swaps.

Although we understand that the Agencies will coordinate with respect to the administration of the Volcker Rule, it would be undesirable and counterproductive for one banking group's various legal entities to be subject to the oversight of multiple regulators with respect to its trading activities, compliance programs and required reporting under the Volcker Rule.¹⁸³ This type of duplication would be less effective, because, as discussed in Section II.A, each regulator may see only part of the whole. It would also be more burdensome for banking entities, be an inefficient use of regulators' time and resources and inevitably result in inconsistent interpretations by different regulators.

(footnote continued)

approximately two and a half years, beginning with implementation for the most liquid bonds (AAA- and other highly-rated credits), which represented the "easiest" case for implementation, and then later expanding to less liquid and high-yield instruments, so as not to harm liquidity or orderly trading in fixed income markets before the consequences of TRACE were fully understood and absorbed by market participants. (Implementation is in fact still ongoing with respect to certain asset classes.) The time within which trades were required to be reported was decreased in stages from 75 minutes to 15 minutes, both to allow dealers to implement the required reporting infrastructure and to minimize the market disruptions that could have occurred if FINRA had started with more rapid public reporting of trades. See *TRACE Fact Book 2010*, FINRA, <http://www.finra.org/Industry/ContentLicensing/TRACE/P085342>.

¹⁸¹ Section __.2(e) of the Proposed Rule.

¹⁸² For example, in the case of a bank holding company, the trading activities of broker-dealer and swap dealer subsidiaries could be subject to Volcker Rule review by the SEC and the CFTC, respectively, as functional regulators, as well as by the Federal Reserve, as the bank holding company's prudential regulator and supervisor. The bank holding company's depository institution subsidiary (or subsidiaries), which may also engage in trading activities, will be subject to regulation by a combination of the Federal Reserve, the OCC and the FDIC. Other subsidiaries of the bank holding company may not be subject to functional regulation by the SEC or CFTC, but will nonetheless be subject to the requirements of the Volcker Rule and will need to be analyzed alongside the functionally regulated subsidiaries.

¹⁸³ The Agencies requested comment on this topic in Question No. 84.

Given these concerns, administration of the Volcker Rule for all entities within a banking entity's affiliate group should be the responsibility of a single regulator.¹⁸⁴ That regulator should be the one that is in the best position to assess compliance by ensuring that the proprietary trading prohibition is administered correctly and consistently across the banking entity's consolidated operations, and that regulator will develop the broadest knowledge of the banking entity's market making, hedging and other permitted activities.

C. Treatment of Affiliate Transactions¹⁸⁵

The definition of "banking entity" in the Proposed Rule includes every subsidiary of a parent organization such as a bank holding company.¹⁸⁶ Although this is required by the Volcker Rule,¹⁸⁷ inter-affiliate transactions may present special issues. For example, for a banking entity with an international market making business, customer trades in non-U.S. jurisdictions may often be executed through a broker-dealer in the non-U.S. jurisdiction but ultimately booked in inventory in several regional "hubs" that are better capitalized and provide a centralized platform for the banking entity to monitor and hedge the risks associated with the inventory (and for its regulator to supervise these activities).

In this case, looking only at the trade between the two affiliates, and the resulting position held in inventory by the larger "hub" entities, might not reveal that the position is the direct result of a customer trade, even when traders in both entities are part of the same "trading unit." The final rule should clarify that the position will be treated as such in any relevant measurements of the banking entity's customer-facing trades or customer revenues. In such a case, their metrics should be calculated without reference to inter-affiliate transactions (which will generally net out within the trading unit). We believe this approach is consistent with the Agencies' permitting an enterprise-wide compliance regime under Section __.20 of the Proposed Rule.¹⁸⁸

¹⁸⁴ The Volcker Rule provides that the Agencies will "coordinate with each other" to "provide for consistent application and implementation" of the Volcker Rule and "avoid providing advantages or imposing disadvantages to the companies affected" by it. Section 13(b)(2)(B)(ii) of the BHC Act. Our suggestion will allow the Agencies to comply with this requirement because it will promote the most straightforward dialogue between a banking entity and its designated regulator and will avoid idiosyncratic scenarios that could arise if a banking entity had different regulators reviewing different aspects of its Volcker Rule compliance.

¹⁸⁵ The Agencies requested comment on this topic in Question No. 5.

¹⁸⁶ Section __.2(e) of the Proposed Rule.

¹⁸⁷ Section 13(h)(1) of the BHC Act.

¹⁸⁸ See NPR at 68918 ("[A] banking entity has discretion to structure and manage its program for compliance. . . in a manner that best reflects the unique organization and operation of the banking entity and its affiliates and subsidiaries. . .").

D. “Riskless Principal” Transactions¹⁸⁹

To implement the statutory exemption for trading “on behalf of customers,”¹⁹⁰ the Proposed Rule provides that three categories of transactions, including “riskless principal” transactions, will qualify for this exemption.¹⁹¹ We recommend that the final rule provide additional clarity as to how “riskless principal” will be interpreted and, in doing so, provide additional flexibility with respect to the availability of this exemption.

The interpretive authorities to which the Preamble to the Proposed Rule refers, namely, the Federal Reserve’s Regulation Y, OCC interpretive letters and the SEC’s Rule 3a5-1 under the Exchange Act, do not all state exactly the same conditions for a transaction to be considered “riskless principal.”¹⁹² Furthermore, in jurisdictions outside of the United States, “riskless principal,” while broadly understood to be the same concept of a trade without market risk, may have different requirements with respect to the timing of trade legs or other terms, either by local regulation or (in the absence of specific rules) market practice. Accordingly, the final rule should provide that the riskless principal exemption will be interpreted flexibly to take into account the variety and diverse nature of asset classes and markets (including in non-U.S. jurisdictions) in which banking entities transact.

¹⁸⁹ The Agencies requested comment on this topic in Question No. 127.

¹⁹⁰ Section 13(d)(1)(D) of the BHC Act.

¹⁹¹ Section __.6(b)(2) of the Proposed Rule (defining a “riskless principal” transaction as one in which “the covered banking entity, after receiving an order to purchase (or sell) a covered financial position from a customer, purchases (or sells) the covered financial position for its own account to offset a contemporaneous sale to (or purchase from) the customer”).

¹⁹² That is, the authorities do not necessarily focus on the same conditions for a transaction to be considered “riskless principal” in the economic sense (before considering any additional regulatory requirements that may be necessary for a *permitted* riskless principal transaction under particular circumstances). For example, the SEC has provided that offsetting legs of a riskless principal transaction must generally take place on the same trading day to be “contemporaneous,” while the Federal Reserve does not appear to have addressed this question. See Order Revising the Limitations Applicable to Riskless Principal Activities, 1996 WL 311860 (June 10, 1996); Buys-MacGregor, MacNaughton-Greenawalt & Co., SEC No-Action Letter [1980 Transfer Binder], Fed. Sec. L. Rep. (CCH) 76,313 (Jan. 2, 1980); SK Int’l Securities Corp., SEC No-Action Letter, 1999 WL 33735137 (Feb. 2, 1999).

Moreover, the statement in the Preamble to the Proposed Rule that riskless principal transactions “do not expose the banking entity to gains or losses on the value of the traded positions, notwithstanding the fact that the banking entity technically acts as principal” (NPR at 68879), is not strictly accurate and should not be construed as an absolute requirement for a riskless principal trade. The SEC, for instance, has acknowledged the prevailing opinion that “a transaction cannot be riskless when a dealer is long or short a security it has purchased from or sold to its customer, even for a minute, since the dealer is exposed to some market risk” (SK Int’l Securities Corp., SEC No-Action Letter at 2). Rather, we believe that the focus of the exemption should be on the degree to which the offsetting legs of the riskless principal transaction were designed to reduce principal risk to the extent reasonably practicable under the circumstances.

E. Treatment of “Debts Previously Contracted” and Clearing-Related Activities

Under their discretionary authority to exempt activities from the prohibitions of the Volcker Rule,¹⁹³ the Agencies propose to permit a banking entity to acquire and retain an ownership interest in, or act as sponsor to, a “covered fund” if the acquisition or retention is done in the ordinary course of collecting a debt previously contracted.¹⁹⁴ We agree that this exemption is appropriate, but the issue is not unique to covered funds and may arise with respect to many types of covered financial positions. Accordingly, we recommend that the final rule exclude from the definition of “trading account” purchases and sales of any covered financial positions that are made in the ordinary course of collecting a debt previously contracted and realizing proceeds from the disposal of collateral.¹⁹⁵

This exclusion would permit banking entities (such as broker-dealers) to continue to provide margin lending to customers, which requires that banking entities (as the lenders) be able, in cases of customer default, to take possession and dispose of the assets as principal. Acting as a secured party enables banking entities to provide a broader range of credit to customers by reducing the banking entities’ own exposure to credit risk from their customers, which is consistent both with banking entities’ own safety and soundness and with financial stability generally. Yet trading out of a customer default may require a banking entity to sell covered financial positions (potentially, though not always, as principal¹⁹⁶) to minimize both its and its customer’s losses. In this case, the banking entity may also need to exercise discretion as to the most appropriate terms and timing of the disposition of the positions. For example, attempting to sell a large portfolio of positions all at once could depress the price received for the portfolio and therefore produce a suboptimal result for both the banking entity and its customer.

In addition, although the Proposed Rule excludes activities of a clearinghouse from the definition of “trading account,” it provides no corresponding exclusion for clearing-related activities of banking entities that serve as clearing members or have their transactions cleared through a clearinghouse. These clearing-related activities should also be excluded because they are not used by banking entities to engage in proprietary trading, are part of a clearinghouse system that helps to reduce systemic risk and in fact may be required by law.¹⁹⁷

Clearing members, for example, intermediate between customers and the clearinghouse, which could be deemed to involve short-term trades in covered financial positions within a “trading account,” especially for clearing members that are also dealers or swap dealers. Furthermore, clearing members may engage in several other types of clearing-related activities, including trading with the clearinghouse itself and accepting positions of a defaulting clearing member, which may be in response to express requests by the clearinghouse itself to bid on such positions (a process that helps to maintain market stability and

¹⁹³ Section 13(d)(1)(J) of the BHC Act authorizes the Agencies to exempt other activities from the prohibitions of the Volcker Rule if the Agencies determine that the activities would promote and protect the safety and soundness of a banking entity and the financial stability of the United States.

¹⁹⁴ Section __.14(b)(1) of the Proposed Rule.

¹⁹⁵ The Agencies requested comment on this topic in Question No. 20.

¹⁹⁶ The disposition of covered financial positions in a foreclosure context may also satisfy the requirements for permitted trading “on behalf of customers.” See Section __.6(b) of the Proposed Rule.

¹⁹⁷ See 7 U.S.C. § 2(h), as amended by Dodd-Frank § 723; 15 U.S.C. § 78c-3 (as added by Dodd-Frank § 763).

continuity of transactions in the event of such a default). Although many clearing-related activities may be on behalf of customers or could be characterized as market making-related, we believe those may be inappropriate standards in this context and may not cover the full range of clearing-related activities. Accordingly, the final rule should exclude clearing-related activities, including the ones described above, from the definition of “trading account,” rather than force banking entities to rely on a hodge-podge of other potential exemptions, to ensure that the Volcker Rule does not inadvertently inhibit the willingness or ability of banking entities to provide clearing services.

F. Scope of Definition of “Trading Account”

The use of the terms “account” and “trading account” in the Proposed Rule¹⁹⁸ is ambiguous.¹⁹⁹ “Account” is not defined, and “trading account” appears to be a conceptual framework for identifying all transactions of a banking entity that meet a set of common criteria used to define “proprietary trading.” In other words, “trading account” does not appear to correspond to any particular “account” as determined for recordkeeping, accounting, tax, operational or legal or regulatory purposes (other than the Volcker Rule). To provide clarity, the final rule should explicitly confirm this interpretation.²⁰⁰

Additionally, the registered dealer “status” test and “market risk capital rule” test are overly broad and unnecessary given that the short-term-trading-intent “purpose” test—which, unlike the other two tests, is derived from the statute—would already capture any positions held with short-term trading intent, which would then be subject to further analysis to determine whether they qualified as market making-related or under another exemption. In view of this, the definition of “trading account” should not include every covered financial position in an SEC- or CFTC-registered dealer.²⁰¹ Such a dealer could hold, for example, long-term investments or shares in a demutualized stock exchange, which are not held for proprietary trading but would be presumed to be under the Proposed Rule. Furthermore, the “market risk capital rule”

¹⁹⁸ Section __.3(b)(2) of the Proposed Rule.

¹⁹⁹ The Agencies requested comment on this topic in Question Nos. 14 and 17.

²⁰⁰ The Proposed Rule also defines proprietary trading as “engaging as principal for *the* trading account of the covered banking entity. . . ,” not a trading account. Section __.3(b)(1) of the Proposed Rule (emphasis added). This supports the interpretation of “trading account” as a “virtual” account aggregating all of a banking entity’s positions that are subject to the prohibition on proprietary trading.

Conversely, if a “trading account” is intended to represent an actual, designated account identifiable on the books and records of a banking entity, then under a literal reading of the Proposed Rule *any* principal trading in that account is “proprietary trading”—and thus prohibited absent an exemption—even if only a small fraction of trading in the account would cause the account to be a “trading account.” At the same time, permitted market making-related, underwriting and hedging activities may be more difficult to discern since they may be spread across multiple actual accounts. These would be entirely counterintuitive and unjustified outcomes, which we believe the final rule should clarify will not be the case.

²⁰¹ The Agencies requested comment on this topic in Question Nos. 20 and 22. Under the Proposed Rule, a covered financial position in a registered dealer is not automatically considered to be in a trading account if it is not “taken in connection with the activities. . . that require [the dealer] to be registered.” Section __.3(b)(2)(i)(C) of the Proposed Rule. However, this is not an analysis that dealers or their regulators are currently required to perform, and it would be inefficient to retain this entirely new “status” test in the final rule rather than rely on the statutory “purpose” test (for which we would say the “status” test serves as only a very rough proxy in the first place).

test should be removed or treated only as an indicative factor in the definition of “trading account.”²⁰² Given that the U.S. market risk capital rule has not been finalized,²⁰³ and that the market risk framework is currently under review by the Basel Committee on Banking Supervision, it is not possible to effectively analyze and comment on the impact that the “market risk capital rule” test would have.

G. Excluded Positions Under Repurchase and Securities Lending Agreements²⁰⁴

The Proposed Rule provides that an account will not be a trading account to the extent that it is used to acquire or take one or more covered financial positions that “arise *under* a transaction in which the covered banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement.”²⁰⁵ To provide additional clarity, this exemption in the final rule should also be reworded to provide that covered financial positions that “arise *in connection with* a transaction in which the covered banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement” will be exempt. This would clarify, in particular, that covered financial positions resulting from the termination of a securities lending agreement would be covered by the exemption.

As the Agencies noted, a banking entity may enter into a securities lending transaction to facilitate settlement of customer trades.²⁰⁶ This is especially true in the case of customer short sales, for which the banking entity may typically borrow securities and cause them to be delivered to the counterparty to whom the customer sold short. Under this arrangement, the banking entity’s right to receive redelivery of the securities from the customer in the future hedges its obligation to redeliver the same securities to the banking entity’s securities lending counterparty. If, however, the securities lending agreement terminates, but the customer’s short position remains open, the banking entity would be left with the economic equivalent of a long position in the securities.²⁰⁷ Our proposed wording for the final rule would clarify that the economic “long position” held by the covered banking entity upon termination of the securities lending agreement will be exempt.²⁰⁸

²⁰² The Agencies requested comment on this topic in Question No. 16.

²⁰³ See Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890 (proposed Jan. 11, 2011).

²⁰⁴ The Agencies requested comment on this topic in Question No. 30.

²⁰⁵ Section __.3(b)(2)(iii)(B) of the Proposed Rule (emphasis added).

²⁰⁶ NPR at 68862 (“This clarifying exclusion is proposed because a position held under a securities lending arrangement can be used, for example, to operate in economic substance and function, as a means to facilitate settlement of securities transactions, and is not based on expected or anticipated movements in asset prices. Accordingly, securities lending transactions do not appear to be the type of transaction intended to be covered by the statutory definition of trading account.”).

²⁰⁷ This situation would arise where (i) the lender recalls the loaned securities and the banking entity does not return them, in which case the lender will purchase the securities in the open market and debit the cost against the collateral posted by the banking entity, or (ii) the banking entity purchases securities in the open market and delivers the purchased securities to the lender to terminate the securities loan. In either case, the banking entity would be left with the economic equivalent of a long position in the underlying securities.

²⁰⁸ We note that this economic “long position” is not the result of proprietary trading, but rather a potential outcome of the interaction between permitted securities lending and meeting the request of a customer to continue to maintain
(footnote continued)

Following the same logic, the exemption for repurchase and reverse purchase agreements²⁰⁹ should be reworded in a corresponding manner. This would clarify, for example, that banking entities could make open market purchases to satisfy delivery obligations under repurchase agreements when the instruments to be delivered are difficult or impossible to borrow. Furthermore, the Agencies should expand the exemption for repurchase and reverse repurchase agreements to also exclude covered financial positions entered into in connection with the rehypothecation of customer securities consistent with applicable regulatory requirements.

Banking entities that are prime brokers may manage their funding requirements in part through rehypothecation of customer securities to the extent permitted by the relevant account agreements and regulations such as SEC Rule 15c3-3 under the Exchange Act. The rehypothecation of customer securities is an established and well-understood market practice and can be structured in a number of ways. For funding purposes a banking entity may deliver rehypothecated customer securities to a third party in exchange for cash and a futures contract under which the banking entity will buy back the securities in the future. In our view, the specific method of financing should not govern the availability of the exemption for repurchase and reverse repurchase agreements. Whether funding is obtained through a repurchase arrangement, a pledge, a sale or a sale with a derivative, the end result is the same: funding for the banking entity under an arrangement that is not intended to benefit from expected or anticipated movements in the price of the rehypothecated securities. The final rule should more clearly permit these activities to manage a banking entity's funding requirements and allow established prime brokerage funding practices to continue.

CONCLUSION

At the January 18, 2012 hearing of the House of Representatives on the Volcker Rule, Representative Bachus noted, “[W]hat we are hearing from not only companies, but consumers is that [the Proposed Rule] will threaten the United States and its financial markets, its capital markets[, which are] the deepest and most liquid in the world.”²¹⁰ He went on to say, “I don’t think it’s an exaggeration [to say that] every trader is going to need a psychiatrist and a lawyer sitting next to him.”²¹¹

We appreciate that this is not the Agencies’ intention. Nonetheless, the final rule will be the guiding document for Volcker Rule compliance as its provisions become effective. Neither banking entities nor their

(footnote continued)

its short position. In our view, this transaction should also appropriately be treated as “on behalf of a customer”; any economic “long position” resulting from the termination of the securities lending agreement has arisen from a customer request to maintain its short position and not from any view of the covered banking entity as to the value of the underlying position.

²⁰⁹ Section __.3(b)(2)(iii)(A) of the Proposed Rule.

²¹⁰ Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation: Hearing before the Subcomm. on Capital Markets and Government Sponsored Enterprises and the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services, 112th Cong. (2012) (statement of Rep. Bachus, Ex. Officio Member, Subcomm. on Capital Markets and Government Sponsored Enterprises, Subcomm. on Financial Institutions and Consumer Credit).

²¹¹ *Id.*

regulators should be put in the position of continually needing to interpret around inaccurate or incomplete descriptions of permitted activities and problematic qualitative requirements. This is especially true because quantitative trading metrics can enable regulators to effectively implement the Volcker Rule's statutory requirements while preserving the operation of the capital markets and avoiding unintended consequences.

Hence, we do believe it is critical that the final rule reflect a meaningful evolution from the Proposed Rule. We are optimistic that this can be done in a way that will ultimately be better for all constituencies. In this letter, we have tried to provide judicious changes to the Proposed Rule that will provide a much stronger foundation as banking entities and their regulators move forward with implementation and gain "live" experience with the Volcker Rule.

*

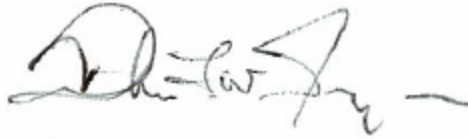
*

*

OCC, Federal Reserve, FDIC, SEC and CFTC
February 13, 2012

We appreciate your consideration of our comments and suggestions on the Proposed Rule. We would be happy to provide any additional information or to discuss any of our comments and suggestions with the Agencies in more detail. Please feel free to contact the undersigned at 212-902-1000.

Sincerely,

A handwritten signature in black ink, appearing to read "John F.W. Rogers", with a horizontal line extending to the right.

John F.W. Rogers
Chief of Staff
The Goldman Sachs Group, Inc.

cc:

Office of Information and Regulatory Affairs
U.S. Office of Management and Budget
New Executive Office Building, Room 10235
725 17th Street, NW.
Washington, DC 20503

Table of Contents

INTRODUCTION	2
The Statutory Requirements and the FSOC’s Recommended Approach	4
Key Problems with the Proposed Rule’s Approach	6
The Most Critical Issues with the Proposed Rule’s Definitions of Permitted Activities	10
Timeline and Process for Implementation and Other Topics	14
I. DETERMINING PERMITTED MARKET MAKING-RELATED, UNDERWRITING AND HEDGING ACTIVITIES	15
A. Permitted Market Making-Related Activities	15
1. The suggestion that “market makers. . . typically only engage in transactions with non-customers to the extent that these transactions directly facilitate or support customer transactions” could severely limit the inter-dealer trading that is critical for market making and hedging in many markets	17
2. The Proposed Rule fails to acknowledge the importance of “activities [that] promote price transparency or liquidity,” including inter-dealer trading to maintain efficient markets	19
3. The requirement to “hold oneself out as being willing to buy and sell” must be broad enough to work across asset classes and different transaction sizes and, in particular, should be less focused on exchange registration and dissemination of unsolicited price quotes as the primary determinants of compliance	22
4. Market makers engage in both “active” and “passive” trading (a distinction that has little meaning when applied to many asset classes and markets, particularly non-U.S. markets)	25
5. The exemption for market making-related activities should not inhibit effective inventory management through overly restrictive anticipatory trading and block resale requirements, and should expressly cover the trading obligations of primary dealers of sovereign obligations	26
6. The sources of a market maker’s revenues vary so much across asset classes and markets that a “primarily from fees, commissions, bid/ask spreads” standard is inappropriate	31
7. The Volcker Rule should not require substantive, dealer-specific regulation for market makers	32
B. Permitted Underwriting Activities	33
1. The definition of “distribution” for purposes of the Volcker Rule should include all primary issuances	34
2. Underwriting-related syndicate activities should more clearly be permitted	35
3. “Customer revenues” in an underwriting transaction should include revenues from syndicate activities, hedging activities and profits and losses on the disposition of residual positions	37
C. Permitted Hedging Activities	38
1. Hedging is intended to mitigate risk, not prevent any new “significant exposures”	39

2.	“Reasonably correlated” is inappropriate as a standard for permitted hedging under the Volcker Rule	40
3.	Examples of hedging transactions that should be permitted, but might not satisfy the “significant exposures” and “reasonable correlation” requirements of the Proposed Rule	41
II.	ADDITIONAL COMMENTS ON THE PROPOSED RULE’S REQUIRED COMPLIANCE REGIME AND QUANTITATIVE TRADING METRICS.....	46
A.	The definition of “trading unit” should be less granular—both because better data will be obtained that way and because it is critical for keeping the costs and logistical challenges of the compliance program at a manageable level	46
B.	“Trade-by-trade” analysis of permitted market making-related, underwriting and hedging activities is not practical and will impair market efficiency by making traders unduly uncertain about the permissibility of their activities	49
C.	Additional comments on quantitative trading metrics required under the Proposed Rule	49
III.	OTHER COMMENTS ON THE PROPOSED RULE	53
A.	Timing of Implementation and Requirements for the Conformance Period	53
B.	Coordination Among Regulators.....	55
C.	Treatment of Affiliate Transactions	56
D.	“Riskless Principal” Transactions	57
E.	Treatment of “Debts Previously Contracted” and Clearing-Related Activities	58
F.	Scope of Definition of “Trading Account”	59
G.	Excluded Positions Under Repurchase and Securities Lending Agreements	60
	CONCLUSION	61