Invesco Ltd.
Two Peachtree Pointe
1555 Peachtree Street, N.E.
Atlanta, GA 30309

Telephone: +1 404 479 1095

February 13, 2012

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street
Washington, D.C. 20581

Mr. John G. Walsh
Acting Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (RIN 3064-AD85)

Ladies and Gentlemen,

I am pleased to have the opportunity to comment on behalf of Invesco Ltd. ("Invesco")[1] regarding the proposed rule (the "Proposed Rule") issued jointly by the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, the Federal Deposit

[1] Invesco is the parent of various entities that are registered as investment advisers under the Investment Advisers Act of 1940, as amended. Certain of these entities are sponsors of and investment advisers to various investment companies registered as such under the Investment Company Act of 1940, as amended. Invesco also is the parent of Invesco National Trust Company, a limited purpose national trust company chartered by the Office of the Comptroller of the Currency.

Insurance Corporation, the Office of the Comptroller of the Currency and the Commodities Futures Trading Commission (collectively, the "Agencies") to implement Section 619 ("Section 619") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2] Invesco is a leading independent global investment manager with over $648 billion in assets as of January 31, 2012 managed through a wide range of investment strategies and vehicles, including open-end and closed-end registered retail funds, institutional money market funds, exchange-traded funds ("ETFs") and unit investment trusts ("UITs"). While Invesco is not directly subject to Section 619, we believe that we can offer valuable insight in our capacity both as a major market participant and as sponsor of a variety of investment management products that could potentially be affected directly by the Proposed Rule. We also believe it important to voice our concerns about the Proposed Rule in order to avoid the serious and unnecessary harms that we believe our clients and investors in funds that we manage will suffer if it is implemented in its current form.

I. Introduction

Section 619 prohibits, subject to specified exemptions, proprietary trading activities carried out by banking entities. We believe that prohibited proprietary trading must be carefully and narrowly defined in the Proposed Rule in order to avoid significant unintended adverse consequences on the capital markets, capital formation and the broader economy. For the reasons discussed below, we believe that the Proposed Rule, as currently drafted, could increase systemic risk by decreasing market liquidity, driving up investor costs, increasing price volatility and triggering both immediate and long-term devaluation of assets. These effects would damage investor confidence and could, in turn, endanger capital formation and the slowly recovering U.S. economy. Invesco therefore requests that the Agencies re-craft the market making exemption from Section 619's ban on proprietary trading contained in the Proposed Rule as a safe harbor for market making. This approach could be coupled with appropriate analytical metrics that could be applied to identify prohibited proprietary trading.

II. Adverse Effects on Investors of Decreased Market Liquidity Caused by the Proposed Rule

The ban on proprietary trading contained in Section 619 is intended to help "minimiz[e] the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities."[3] However, in pursuing this goal, Congress

---

[2] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (November 7, 2011) (the "Proposing Release"). Please note that Invesco will file a copy of this comment letter with the Commodity Futures Trading Commission (the "CFTC") at such time as the CFTC is accepting comments to the Proposed Rule.

[3] Section 13(b)(1)(B) of the Bank Holding Company Act of 1956 (the "Bank Holding Company Act"), as codified by Section 619 of the Dodd-Frank Act.

explicitly recognized the importance of maintaining orderly and efficient capital markets by including exceptions from the proprietary trading prohibition for certain designated “permitted activities” including, among others, market making activities. This statutory provision is designed to promote the countervailing systemic objectives of promoting market liquidity, decreasing investor costs, decreasing price volatility and maintaining asset valuations. Promoting these objectives helps to maintain the degree of investor confidence that is fundamental to the proper functioning of the capital markets and, more broadly, capital formation and the health of the broader economy. Chairman Shapiro has aptly described these activities, which provide a principal source of market liquidity, as “integral to the effective operations of the securities markets.”[4]

Unfortunately, the Proposed Rule’s market making exception does not reflect properly the manner in which securities markets, particularly less liquid ones such as fixed income markets, actually operate and the ways in which market makers carry out their functions. The Proposed Rule potentially prohibits the principal trading that is a necessary element of making markets in many securities and employs a “guilty until proven innocent” approach that unjustifiably equates this form of principal trading with risky proprietary trading unless the market maker can demonstrate otherwise by satisfying a dizzying array of conditions. The Proposing Release acknowledges the problems inherent in distinguishing between beneficial market making and undesirable proprietary trading, conceding that “it may be difficult to determine whether principal risk has been retained because (i) the retention of such risk is necessary to provide intermediation and liquidity services for a relevant financial instrument or (ii) the position is part of a speculative trading strategy designed to realize profits from price movements in retained principal risk.”[5] The Proposed Rule purports to accommodate market making activities but several elements of the related exception, as well as the general complexity of the associated compliance regime, lead us to conclude that the exemption effectively would be unusable for many entities wishing to continue providing their traditional market making services, particularly in less liquid markets. These include the market for fixed-income securities and less liquid equity securities.

The principal function of a market maker in fixed-income securities or less liquid equity securities, which are traded “over-the-counter” as opposed to on securities exchanges, is to stand as a ready buyer or seller of securities at all times, regardless of demand or supply for the

---

[4] *See*, Testimony of Mary Shapiro, Chairman of the Securities and Exchange Commission, at Joint Hearings of the Capital Markets and Government Sponsored Enterprises Subcommittee and the Financial Institutions and Consumer Credit Subcommittee, House Financials Services Committee, *Examining the Impact of the Volcker Rule on Markets, Business, Investors and Job Creation,* January 18, 2012 (the “Joint Hearing”).

[5] Proposing Release, pp. 90-1.

security in the market generally at a given time. This is sometimes described as providing "immediacy." In order to fulfill this function the market maker must manage its inventory in the security and, in so doing, expose itself to the principal risk that the security may lose value during the period of time between its purchase and sale of the security, which may be protracted depending on market demand for the security. This is in contrast to the agency trading role (i.e., matching willing buyers and sellers) that market makers more commonly serve with respect to exchange-traded equities.

Of course, a security may also appreciate in value while held in inventory. Under the Proposed Rule, however, any such appreciation would conflict with the requirement that the market maker's revenues be generated primarily from customer revenues as opposed to price appreciation. The manner in which the Proposed Rule seeks to implement the statutory requirement that market making trading activity must track "reasonably expected near-term demands of clients, customers or counterparties"[6] is similarly problematic since it could effectively transform a poor judgment of market demand from a bona fide miscalculated business decision into cause for an enforcement action for violation of the Proposed Rule.

Likewise, the hedging requirements of the Proposed Rule are premised on the faulty assumption that there is an appropriate and easily available hedge for each principal position that a dealer may take when making a market in a security. For example, it is not possible for a dealer that takes a market-making position in municipal agency bonds, which are not exempt from the proposed proprietary trading restriction, to take a corresponding short position in those bonds since municipal futures are unavailable. By effectively requiring banks to hedge all of their principal positions in order to qualify for the exemption, the Proposed Rule could force market makers to engage in artificial and uneconomic hedging activity.

It is important to note that the potential adverse effects of the Proposed Rule would not be limited to fixed-income markets. As equity markets have become more complex and fragmented, large investors such as mutual funds and pension plans increasingly rely on dealers to facilitate large block transactions through the use of the dealer's capital. Trading in this manner greatly enhances institutional liquidity while at the same time minimizing the market impact these large purchases and sales may otherwise have in the marketplace. Because the Proposed Rule does not properly take into account the way that market making is actually carried out, it risks significantly reducing market liquidity by causing banks and other entities that would be subject to the Proposed Rule to terminate or significantly curtail their traditional market making activities. This reduction in liquidity would result in higher costs for all investors, including pension plan participants, mutual fund shareholders and individual investors. Given the underlying economics of market making businesses, we seriously doubt that a significant

[6] Section 13(d)(1)(B) of the Bank Holding Company Act

number of other entities that are not subject to Section 619 will step in to provide the market liquidity that has historically been supplied by banking entities.

Adequate liquidity is a fundamental requirement for healthy capital markets. Lack of liquidity drives up costs for investors. It also increases market volatility which, in turn, damages investor confidence, a phenomenon that investment managers and others witnessed firsthand during the recent financial crisis that led to the passage of the Dodd-Frank Act, including Section 619. The central role played by liquidity in mitigating market volatility was clearly demonstrated by its absence throughout the market crisis of 2007-09, when overall and bid/offer spreads widened dramatically and fixed income asset valuations changed quickly and drastically during the extended period of market illiquidity. This volatility further eroded investor confidence and in some cases severely depressed prices of thinly traded securities.

Market liquidity is particularly important for mutual funds and other daily liquidity vehicles, which generally trade their portfolio holdings in large volumes and are legally or contractually required to redeem their shares daily at net asset value upon shareholder request. If a mutual fund is forced to liquidate portfolio holdings at lower prices due to a reduction in available liquidity, the remaining shareholders will suffer from the corresponding reduction in value of the fund. This concern is particularly acute in light of the fact that mutual funds represent a large portion of individual investors' retirement savings

We strongly concur with the assessment of Professor Darrell Duffie of Stanford University that the Proposed Rule's "attempt to disentangle those trades that have market making intent from those that do not is likely to be effective only in reducing the capacity of market making services provided by banks."[7] The Proposed Rule appears to include an implicit assumption that following its implementation market-making activity will continue as usual while undesirable, risky proprietary trading will be deterred. We believe, however, that due to the Proposed Rule's overbroad proscriptions, overly narrow exceptions and onerous compliance burdens, banks and other dealers currently providing these services will choose to limit their activities only to the most liquid market segments (where there is less risk of inadvertently running afoul of the proprietary trading restrictions) or exit this business line entirely, thereby reducing both the breadth and depth of markets. Finally, we note that market trading volumes have declined significantly in recent months, with U.S. dealer holdings of corporate issues at their lowest level in nearly 10 years, largely due to concerns over compliance with potentially more stringent capital and risk rules.[8]

[7] See comment letter titled "Market Making Under the Proposed Volcker Rule" submitted by Professor Darrell Duffie on January 16, 2012, p. 22.

[8] "Japan and Canada warn on Volcker rule impact" Financial Times, January 11, 2012.

In light of the foregoing, we strongly urge the Agencies to revise the proprietary trading provisions of the Proposed Rule in a manner that both (1) recognizes the critical role that market making plays in the capital markets in narrowing spreads and reducing volatility, thereby reducing costs to investors and maintaining investor confidence in efficient and orderly capital markets, and (2) reflects the manner in which those market making activities that Congress sought to protect are actually provided. Invesco believes that rather than the current structure of a narrowly defined exception with onerous and detailed metrics and compliance burdens that are overly focused on individual securities transactions, the Agencies instead should create a broad market making activities safe harbor that presumes the majority of trades are market making activity. This approach could be coupled with overall portfolio level metrics to identify whether banks have engaged in prohibited proprietary trading. Such portfolio level metrics could include the percentage of trades for clients, aging of securities inventories, percentage of trading activity profits earned from appreciation or depreciation of available for trade inventories and various portfolio level calculations of Value at Risk (VaR). Invesco would be pleased to discuss the details and construction of such metrics with appropriate representatives of the Agencies.

Section 619 is intended to help ensure the safety and soundness of U.S. banks that benefit from deposit insurance and liquidity facilities of the federal government. We appreciate the importance of those public policy objectives in mitigating systemic risk to our financial system and broader economy. In pursuing this important goal, however, we believe that it is also critical for the Agencies to consider carefully the potential impact of the Proposed Rule on the stability and efficient function of the capital markets and the concomitant effects on capital formation and the broader economy. For the reasons discussed above, we believe that each of these would be significantly damaged by implementation of the Proposed Rule as currently drafted. We further believe the potential benefits of promoting safety and soundness of the financial system under the Proposed Rule are outweighed by its potential systemic negative consequences for the capital markets, capital formation and the broader economy. Congress intended otherwise in the manner in which it sought to protect market making activities under Section 619. We therefore strongly urge the Agencies to revise the proprietary trading provisions of the Proposed Rule in the manner described above to reflect better the manner in which those market making activities that Congress sought to protect are conducted.

Yours sincerely,

Mark L. Flanagan

Martin L. Flanagan
President and Chief Executive Officer