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FIA

April 16, 2012

Via Electronic Submission

David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, RIN 3038–AD05

Dear Mr. Stawick:

The Futures Industry Association ("FIA") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission" or the "CFTC") proposed rules (the "Proposal")[1] to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as the "Volcker Rule." We appreciate the Commission's efforts, and those of the other federal agencies required to implement the Volcker Rule (the "Agencies"),[2] to seek to design rules that are consistent with the Dodd-Frank Act and that avoid unnecessary harm to customer-oriented activities of banking entities. But like many other

[1] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (Feb. 14, 2012), *available at* http://cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-935a.pdf [hereinafter *Proposal*]. While citations in this letter are to the CFTC's Proposal, references to the term "Proposal" in this letter include the joint proposal to implement the Volcker Rule that was separately issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission, which is substantively similar to the CFTC's proposed rules. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-11-07/pdf/2011-27184.pdf. The rule identifiers for the joint proposal are Docket No. R-1432, RIN 7100-AD82 (Board); RIN 3064-AD85 (FDIC); Docket No. OCC-2011-0014, RIN 1557-AD44 (OCC); File Number S7-41-11, and RIN 3235-AL07 (SEC).

[2] The Agencies include the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission.

commenters, the FIA has serious concerns about the Proposal. We believe that the Proposal fails in several key respects to reflect the intent and text of the Volcker Rule. For these reasons, and because of its potentially significant, negative effects on the U.S. financial system and the U.S. economy, the CFTC and the Agencies should reconsider the Proposal.

Our comments and recommendations focus on several aspects of the Proposal that are of particular importance to our members and that we believe should be reassessed by the CFTC and the Agencies. To highlight the importance of the Proposal to our members, we first provide a brief background of the FIA and its members and describe our general concerns about the Proposal. In Section II, we provide specific recommendations for modifications to the Proposal. We first explain why forward contracts and other physically settled contracts should be excluded from the scope of the Volcker Rule. We then discuss how the Proposal should be modified to allow banking entities needed flexibility in trading foreign exchange forwards and swaps, forwards and swaps on U.S. and foreign government obligations, and foreign government obligations. We next explain the need to narrow the definition of "similar funds" to avoid the inclusion of commodity pools and other funds that do not resemble hedge funds or private equity funds. Finally, in Section III, we address the questions raised by the CFTC that are unique to its Proposal.

The FIA also supports the comments and recommendations submitted by the Securities Industry and Financial Markets Association ("SIFMA"), The Clearing House, The Financial Services Roundtable, and the American Bankers Association, the International Swaps and Derivatives Association, Inc. ("ISDA"), and the Investment Company Institute ("ICI").[3] We urge the CFTC and the Agencies to consider the serious concerns raised about the Proposal discussed herein and in the letters of other industry participants and to modify the Proposal accordingly.

I. FIA Members' General Concerns about the Proposal

The FIA's members are central participants in the U.S. futures and over-the-counter derivatives markets. They include futures commission merchants, their affiliated swap dealers and commodity pool operators, and U.S. exchanges and clearinghouses. Many FIA members

[3] Letter from SIFMA, The Clearing House, The Financial Services Roundtable, and the American Bankers Association to the Agencies (Proprietary Trading) (Feb. 13, 2012), *available at* http://www.sifma.org/volcker-comment-letter1/ [hereinafter *SIFMA Prop Comment Letter*]; Letter from SIFMA, The Clearing House, The Financial Services Roundtable, and the American Bankers Association to the Agencies (Hedge Funds and Private Equity Funds) (Feb. 13, 2012), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=8589937355 [hereinafter *SIFMA Funds Comment Letter*]; Letter from ISDA to the Agencies (Feb. 13, 2012), *available at* http://www2.isda.org/attachment/NDAwNA==/ISDA%20Comment%20Letter%20-%20Volcker%20Rule%20FINAL.pdf [hereinafter *ISDA Comment Letter*]; Letter from Investment Company Institute to the Agencies (Feb. 13, 2012), *available at* http://www.ici.org/pdf/25909.pdf [hereinafter, *ICI Comment Letter*].

will be directly subject to the Volcker Rule as bank affiliates. These members are major participants in key futures, options, and other derivatives markets.

Bank-affiliated FIA members engage in futures and other derivatives transactions as part of their customer intermediation, market making, and credit-related services, and they are primary providers of these customer-oriented services. They are also key liquidity providers in these markets. Other FIA members are direct customers or participants in one or more of the futures and other derivatives markets in which U.S. banks and their affiliates are important liquidity providers. Whether they are directly subject to the Volcker Rule or affected by it as customers of banking entities or participants in markets in which banking entities are key liquidity providers, the core businesses of FIA members will be impacted by the Volcker Rule and regulations adopted to implement it.

We recognize that the CFTC's and the Agencies' efforts to implement the Volcker Rule are guided by certain clear parameters set out in the Rule and that some activities that banking entities may have engaged in previously, such as short-term, speculative risk taking, will need to be reconsidered. However, we believe that the CFTC and the Agencies have chosen an approach that is at odds, in many respects, with the statutory text and that would be unnecessarily harmful to vital commodity, futures, and other derivatives markets by reducing the ability of U.S. banking entities to provide customer-oriented services in these markets, thus depriving them of needed liquidity.

Some commenters have expressed the view that the Proposal, as published by the Agencies, does not go far enough and should take a more proscriptive approach to implementing the statutory text.[4] We respectfully disagree. We believe that the Proposal's directives go well beyond the requirements of the statutory text and could jeopardize vital market activity, as discussed in detail in comment letters filed by SIFMA, ISDA, the ICI, and others, with which we agree.[5] While this letter does not discuss in detail these broader concerns, we urge the CFTC, together with the Agencies, to carefully assess the impact of Volcker Rule implementing regulations on market liquidity and the ability of U.S. banking entities to provide critical financial services to their customers.

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[4] Letter from U.S. Senators Merkley and Levin to the Agencies (Feb. 13, 2012), *available at* http://www.federalreserve.gov/SECRS/2012/February/20120216/R-1432/R-1432_021412_104998_542080912901_1.pdf [hereinafter *Merkley-Levin Comment Letter*]; Letter from Americans for Financial Reform to the Agencies (Feb. 13, 2012), *available at* http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2012/02/AFR-Comment-Letter-Volcker-Rule-2-13-122.pdf.

[5] *SIFMA Prop Comment Letter; SIFMA Funds Comment Letter; ISDA Comment Letter; ICI Comment Letter.*

II. Specific Recommendations

Our specific recommendations for modification of the Proposal are based on our members' deep experience in and knowledge of the futures and derivatives markets. In particular, we make the following recommendations:

- Exclude forwards contracts and other physically settled contracts from the definition of covered financial position;
- Exclude foreign exchange forwards and swaps from the definition of derivative;
- Include in the scope of permissible government obligation activities transactions in futures and swaps on U.S. government obligations;
- Include in the scope of permissible government obligation activities transactions in foreign sovereign debt and in futures and swaps on those obligations; and
- Include only those commodity pools and foreign funds in the definition of "similar funds" that are, in fact, similar to hedge funds or private equity funds.

We believe that these recommendations are consistent with the statutory text of the Volcker Rule and congressional intent and would prevent unnecessary harm to financial and commercial markets that are at the core of the U.S. economy.

A. Exclude forwards contracts and other physically settled contracts from the definition of covered financial position.

The Proposal would subject forward contracts to the Volcker Rule's restrictions on proprietary trading by including them in the Proposal's definition of "derivative," one of the specified categories of covered financial positions.[6] Specifically, the proposed definition of derivative includes "[a]ny purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled,"[7] which is the definition of "forward contract" as used in Title VII of the Dodd-Frank Act and a close equivalent of the forward contract definition used in the Commodity Exchange Act and CFTC guidance for many decades.[8] For the

[6] *Proposal,* Proposed Rule __.3(b)(B).

[7] *Proposal,* Proposed Rule __.2(l)(i)(B).

[8] Section 721 of the Dodd-Frank Act; Section 1a(27) of the Commodity Exchange Act; *see, e.g.,* Commodity Futures Trading Commission, Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39188 (Sept. 25, 1990).

reasons discussed below, we believe that the Proposal improperly includes forwards and other physically settled contracts within the scope of the Volcker Rule proprietary trading provisions.

1. Forward contracts should be excluded from the Volcker Rule.

In subjecting forwards to the Volcker Rule proprietary trading provisions, the Proposal is at odds with the plain text of the statute as well as Congress's evident intent in adopting it. The Volcker Rule's proprietary trading provisions apply, by their terms, to "any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that [the Agencies determine by rule]."[9] In a comment letter filed with the Agencies on the Volcker Rule, Senators Merkley and Levin contend that "[t]he law provides no statutory authority to exclude transactions involving spot commodities or forward contract transactions that are to be physically settled from the [Volcker Rule], nor should they be excluded."[10] They also state that spot commodity and forward transactions are subject to the Volcker Rule by virtue of the reference in the statute to "any other security or financial instrument."[11] We respectfully disagree.

Neither spot commodity contracts nor forward contracts are included in the list of instruments subject to the Volcker Rule's proprietary trading ban. Indeed "commodities" were specifically included in earlier versions of the Volcker Rule passed by the Senate and House, but the term was omitted from the final version's list of instruments covered by the prohibition on proprietary trading.[12] This sequence of events is compelling evidence of congressional intent to

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[9] Section 13(h)(4) of the Bank Holding Company Act, as amended by Section 619 of the Dodd-Frank Act (defining the term "proprietary trading" for purposes of the Volcker Rule provisions).

[10] *Merkley-Levin Comment Letter* at 10.

[11] *Id.*

[12] As originally drafted by the Treasury Department in March 2010, the Volcker Rule defined proprietary trading as "purchasing or selling, or otherwise acquiring and disposing of, stocks, bonds, options, *commodities*, derivatives, or other financial instruments . . . ." (Emphasis added.) This language appears verbatim in Senator Dodd's financial reform bill, S. 3217, reported out of the Committee on Banking, Housing and Urban Affairs on March 22, 2010. S. 3217, 111th Congress § 619 (2010), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-111s3217pcs/pdf/BILLS-111s3217pcs.pdf. Under this definition, all commodities transactions, including spot and forward transactions, would have been covered by the Volcker Rule. Under the House's companion legislation on financial reform, H.R. 4173, proprietary trading was defined as "trading of stocks, bonds, options, *commodities*, derivatives, or other financial instruments . . . ." (Emphasis added.) H.R. 4173, 111th Congress § 1117 (2010), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173eh/pdf/BILLS-111hr4173eh.pdf. On March 10, 2010, Senators Merkley and Levin introduced an alternative version of the Volcker Rule, S. 3098, which contained the following formulation: "any stock, bond, option, *contract of sale of a commodity for future delivery*, swap, security-based swap, or any other security or financial instrument which the Board and the Federal Deposit Insurance Corporation shall jointly, by rule, determine." (Emphasis added.) S. 3098, 111th Congress, *available at* http://www.gpo.gov/fdsys/pkg/BILLS-111s3098is/pdf/BILLS-111s3098is.pdf. On May 10, Senators Merkley and Levin filed a modified version of their bill that contained the language: "any security, *contract of sale of a*
(...continued)

exclude *all* commodities from the scope of the Volcker Rule.[13] The action removes both spot contracts and forward contracts from the ambit of the Rule: forward and spot contracts are closely linked variants of commodity transactions, distinguished principally by their settlement periods.[14]

The CFTC and the Agencies acknowledge that spot commodities are not subject to the Volcker Rule and do not include them in the derivatives definition of the Proposal.[15] However, rather than taking a consistent approach to forward contacts, the CFTC and the Agencies specifically include forward contracts in the Proposal's definition of derivative. We believe that the Proposal's treatment of forwards as derivatives is inappropriate for several reasons.

First, forward contracts have never been treated as derivatives; they have been recognized since the earliest federal commodities legislation as commercial merchandising transactions outside the proper scope of regulation under the Commodity Exchange Act. Section 1a(27) of

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commodity for future delivery, any option on any such contract, swap, security-based swap, or any other security or financial instrument that the appropriate Federal banking agencies, in consultation with the Securities and Exchange Commission and the Commodity Futures Trading Commission, may jointly, by rule, determine." (Emphasis added.) On May 20, 2010, the Senate passed S. 3217, which continued to reference simply "commodities." S. 3217, 111th Congress, *available at* http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173eas/pdf/BILLS-111hr4173eas.pdf. The Senate-passed bill served as the base text for the subsequent Conference Committee negotiations. Section 619, containing the Volcker Rule, was amended in conference on June 24. As explained by Senator Dodd during the televised conference proceedings, the amendments to the Volcker Rule implemented various changes to the base text suggested by Senators Merkley and Levin. The relevant portion of the proceedings can be viewed here: http://www.c-spanvideo.org/program/BillDay7Par/start/0/stop/418. As reflected in the final bill, the Merkley-Levin language removing the term "commodities" and instead including "contract of sale of a commodity for future delivery" was among these changes. This final substitution of the Merkley-Levin text for the Treasury Department text (which, as noted above, originated in the 2009 House bill) indicates that Congress considered and ultimately rejected a broader definition of proprietary trading that included not only commodity futures transactions but also spot and forward transactions.

[13] Courts have considered the sequence of changes leading to final legislative text as evidence of congressional intent. Indeed, the U.S. Supreme Court stated that "[f]ew principles of statutory construction are more compelling than the proposition that Congress does not intend *sub silentio* to enact statutory language that it has earlier discarded in favor of other language." Nachman Corp. v. Pension Benefit Guaranty Corporation, 446 U.S. 359, 392 (1980). *See also* Doe v. Chao, 540 U.S. 614, 622 (2004) ("drafting history show[s] that Congress cut the very language in the bill that would have authorized any presumed damages"); Congressional Research Service, Statutory Interpretation: General Principles and Recent Trends (Aug. 31, 2008), *available at* http://www.fas.org/sgp/crs/misc/97-589.pdf.

[14] *See, e.g.*, CFTC Glossary defining both "spot" and "forward" contracts as cash transactions and distinguishing them from futures contracts. CFTC Glossary, http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm.

[15] *Proposal* at 8349.

the Commodity Exchange Act, known as the forward contract exclusion, clearly provides that federal regulation under the Commodity Exchange Act does not reach any aspect of forward contracts.[16] The distinction between futures contracts, which have been regulated under the Commodity Exchange Act for nearly a century, and forward contracts, which have never been regulated, is a bedrock tenet of the Commodity Exchange Act.[17] The Dodd-Frank Act also explicitly excludes forwards from the definition of swap under Title VII of the Dodd-Frank Act, which covers most types of derivatives.[18]

Moreover, the Proposal is in fact self-contradictory in its treatment of forwards. On the one hand, it explicitly *includes* forwards within the definition of derivative. On the other, it explicitly *excludes* from that definition instruments the SEC and CFTC have proposed to exclude from the term "swap" under Title VII of the Dodd-Frank Act. The CFTC and SEC joint proposal on the swap definition clearly confirms that forwards are excluded from the definition of swap, based upon the fact that forwards are part of the underlying commercial market and are not derivatives.[19] We believe this inconsistency in the Proposal should be resolved in favor of treating forwards in a manner that accords with the plain language of, and congressional intent underlying, the Volcker Rule and with existing law recognizing forwards as commercial, not financial, contracts. In short, for the reasons discussed above, we urge the CFTC and the Agencies to exclude forwards from the scope of the Volcker Rule.

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[16] Section 1a(27) of the Commodity Exchange Act excludes from the term future delivery "any a sale of any cash commodity for deferred shipment or delivery." This, in effect, excludes forward contracts from regulation under the Commodity Exchange Act. For a more detailed description of the forward contract exclusion, see Commodity Futures Trading Commission & Securities Exchange Commission, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Recordkeeping, 76 Fed. Reg. 29818, 29828 fn 57 (May 23, 2011), *available at* http://cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-11008a.pdf.

[17] As is well known to the CFTC, the Volcker Rule reference to "any contract of sale of a commodity for future delivery" replicates the Commodity Exchange Act term for futures contract, which expressly excludes "any sale of any cash commodity for deferred shipment or delivery." Commodity Exchange Act Section 1a(19). *See also* Commodity Futures Trading Commission, Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39188 (Sept. 25, 1990).

[18] Section 721 of the Dodd-Frank Act (excluding from the definition of swap "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled").

[19] Commodity Futures Trading Commission & Securities Exchange Commission, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Recordkeeping, 76 Fed. Reg. 29818, 29828 fn 57 (May 23, 2011), *available at* http://cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-11008a.pdf.

2. *Other physically settled transactions, such as physically settled over-the-counter ("OTC") options on spot commodities and forward contracts, should be excluded from the Volcker Rule.*

Physically settled transactions, such as OTC options on spot commodities and forwards, should be excluded from the Volcker Rule for reasons closely related to those that support the exclusion of forward contracts. Like forwards, physically settled OTC options are not included in the statutory list of instruments covered by the Volcker Rule's prohibition on proprietary trading. The statutory text refers to options only on specifically enumerated instruments – "any such security, derivative, or contract [of sale of a commodity for future delivery (*i.e.*, a futures contract)].[20] Thus, a plain reading of the Volcker Rule compels the conclusion that Congress intended to include within the scope of the proprietary trading ban any options on securities (*e.g.*, a listed equity option), options on derivatives (*e.g.*, a swaption), and options on futures contracts, but not OTC options on spot commodity contracts or forward contracts. Physically settled options on spot commodities and forward contracts, like forward contracts, must therefore be excluded from the Volcker Rule's proprietary trading ban based upon Congress's determination to carve "commodities" out of the statutory definition of proprietary trading. If such options were included, the "commodities" Congress sought to exclude would be brought back within the prohibition despite being specifically excluded from the statute.

Moreover, like spot and forward transactions, physically settled OTC options are transactions for the purchase or sale of specific commodities for delivery at a future date. OTC options that upon exercise result in the physical delivery of a commodity on a spot or forward basis are commonly used by operating companies to manage their supply of commodities and risks associated with their commodity-related businesses. Their commercial functions are fundamentally linked to, and often indistinguishable from, those of spot commodity transactions and forward transactions. For these reasons, the CFTC and the Agencies should exempt physically settled contracts from the Volcker Rule.

However it may be implemented, the Volcker Rule will, to some extent, impair liquidity in every asset class that it touches. In the context of commodity markets, this liquidity concern is made particularly acute by the lack of certainty currently surrounding the meaning of the term "spot" in relation to commodities, where standard delivery periods can extend to weeks and perhaps even months. We believe that there is ample evidence that commercial agreements such as forward contracts and options on spot commodity contracts and forward contracts should not be considered "financial instruments" as that term is used in the proprietary trading provisions of the Volcker Rule and, as such, should not be made subject to the restrictions of the Rule. We

[20] Section 13(h)(4) of the Bank Holding Company Act, as amended by Section 619 of the Dodd-Frank Act (defining the term "proprietary trading" for purposes of the Volcker Rule provisions).

strongly encourage the agencies to refrain from extending the statute to asset classes that are clearly commercial, as opposed to strictly financial, in nature.

B. Exclude foreign exchange forwards and swaps from the definition of derivative.

The Proposal also subjects foreign exchange forwards and swaps to the Volcker Rule by including them in its definition of "derivative."[21] This result is inconsistent with the treatment under Title VII of the Dodd-Frank Act of the very same instruments and is not required by the Volcker Rule. Under Title VII, the Treasury Secretary has the authority, and has proposed, to exclude foreign exchange forwards and swaps from regulation.[22] Treasury's proposal reflects key differences between these instruments and other instruments regulated as swaps. Treasury's proposal reflects the distinctive character of foreign exchange swaps and forwards: the parties to the transactions know their own and their counterparties' payment obligations and the full extent of their exposure throughout the life of the contracts, and settlement requires the exchange of the full principal amount of the contract in two different currencies rather than the incremental profit or loss in the transaction.[23]

As Treasury commented, this physical settlement requirement contributes to a risk profile largely concentrated in settlement risk. Payment-versus-payment ("PVP") settlement protocols and other settlement risk mitigation measures, as well as the short duration of the transactions, provide a cogent basis for treating these transactions as outside the scope of most swap requirements. Treasury also observed that foreign exchange forwards and swaps are "more similar to funding instruments, such as repurchase agreements." The Proposal appropriately excludes repurchase agreements from the Volcker Rule, and it should take the same approach with respect to foreign exchange forwards and swaps.

Moreover, in proposing to exclude foreign exchange forwards and swaps from Title VII of the Dodd-Frank Act, Treasury also notes that "banks are the key players in the foreign exchange swaps and forwards market"[24] and that foreign exchange activities of banks are already subject to significant oversight. The CFTC and the Agencies should apply these same considerations to the treatment of foreign exchange forwards and swaps. These instruments are critical to U.S. monetary policy, global payment systems, end users engaged in international trade, and other businesses that require these transactions for hedging and other commercial

[21] *Proposal,* Proposed Rule __.2(l)(i)(C).

[22] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25774, 25776 (May 5, 2011).

[23] *Id.*

[24] *Id.* at 25777.

purposes. The CFTC and the Agencies should avoid serious disruption of this critical market and should exclude foreign exchange forwards and swaps from the Volcker Rule.

C. Include in the scope of permissible government obligation activities transactions in futures and swaps on U.S. government obligations.

The Volcker Rule expressly permits a banking entity to trade in specified U.S. government, U.S. government agency, government-sponsored entity, and U.S. state issued securities under an exception to the proprietary trading ban.[25] However, under the Proposal this permitted activity is narrowly framed to cover only the specified U.S. government obligations themselves and does not reach futures contracts or swaps on these obligations. We believe that the CFTC and the Agencies should permit banking entities to trade futures and swaps on U.S. government obligations under the permitted activity exception for U.S. government obligations.

Trading in derivatives on U.S. government obligations is inextricably linked to liquid markets in the underlying obligations. Banking entities transact in derivatives on these instruments and the underlying obligations in integrated trading and portfolio management programs. If the permitted activity is confined to the underlying government obligations, the activity expressly permitted by Congress is likely to be significantly reduced. Banking entities commonly employ futures, options on futures, and other derivatives in addition to U.S. government obligations to manage risk, and the ability to choose among these instruments enables them to maximize efficiency and reduce risk. The impact of constraining these activities is likely to include decreased liquidity in the Treasury market, Agency securities market, and other government obligations markets, a result at odds with the congressional intent to permit banking entities to transact in U.S. government obligations.

D. Include in the scope of permissible government obligation activities transactions in foreign sovereign debt and in futures and swaps on those obligations.

As noted above, the Volcker Rule explicitly permits banking entities to trade in U.S. government obligations. The CFTC and the Agencies should interpret this exemption to include debt obligations of foreign governments and international and multinational development banks, to the extent that such trading is otherwise permissible for banking entities. Permitting banking entities to transact in these instruments as part of the permitted activity exception for government obligations is vital to preserving the ability of banking entities to use foreign sovereign debt and related derivatives for liquidity management and collateral purposes. Limiting the exception to U.S. government obligations would reduce liquidity in comparable non-U.S. government instruments routinely employed by banking entities operating internationally and would reduce

[25] Section 13(d)(1)(A) of the Bank Holding Company Act, as amended by Section 619 of the Dodd-Frank Act.

their ability to manage concentration risk. Moreover, as discussed by Canadian regulators, the Japanese Bankers Association, Chancellor of the Exchequer George Osborne, and E.U. Markets Commissioner Michel Barnier,[26] principles of comity require permitting banking entities to trade foreign sovereign debt on the same terms as their activities in U.S. government obligations.

Trading in futures and swaps on foreign sovereign debt and multinational debt also should, for the same reasons as discussed above for futures and swaps on U.S. government debt, be covered under the permitted government obligations activities exception. These instruments are regularly used by banking entities and their customers as part of an integrated portfolio, and separating trading activities in the underlying obligations from those in derivatives on these obligations would artificially divide a market that is pervasively connected. Failing to include futures and swaps on foreign sovereign debt and obligations of multinational organizations would impair the markets for these obligations by limiting the ability of banking entities to act as liquidity providers for these instruments. This result is inconsistent with the purposes of the Volcker Rule and is not required under the terms of the Rule.

E. Include only those commodity pools and foreign funds in the definition of "similar funds" that are, in fact, similar to hedge funds or private equity funds.[27]

The Proposal would impose the Volcker Rule prohibition on sponsoring and investing in hedge funds and private equity funds upon all U.S. and foreign commodity pools and virtually all foreign funds,[28] regardless of whether these vehicles are similar to hedge funds or private equity funds.[29] This results in U.S. mutual funds that trade commodity interests, publicly offered commodity pools, publicly offered and regulated foreign funds (regardless whether they trade in commodity interests), and other vehicles that are not similar either from a regulatory or operational standpoint to hedge funds or private equity funds being covered by the Volcker Rule. This is inconsistent with the text of the Rule, which specifies that federal regulators may

[26] Letter from Julie Dickson, Office of the Superintendent of Financial Institutions Canada, to the Agencies (Dec. 28, 2011); Letter from Gadi Mayman, Ontario Financing Authority, to the Agencies (Jan. 31, 2012); Letter from Luc Monty, Ministry of Finance of Quebec, to the Agencies (Feb. 9, 2012); Letter from Japanese Bankers Association to the Agencies (Jan. 13, 2012); Letter from Michel Barnier, European Commissioner for Internal Market and Services, to the Agencies (Feb. 8, 2012).

[27] This discussion in part responds to question 218.1 in the Proposal, which asks whether the definition of covered fund to include all commodity pools is too broad.

[28] We use the term foreign funds to mean funds organized and offered outside the United States.

[29] *Proposal,* Proposed Rule __.10(b)(1)(ii) and (iii). The Proposal would not cover foreign funds that could rely on an exclusion from the definition of investment company under the Investment Company Act of 1940 other than those in Section 3(c)(1) or 3(c)(7) of that Act. For a more detailed discussion of the types of foreign funds that could be subject to the Volcker Rule under the Proposal, see the *SIFMA Funds Comment Letter* at C-36.

designate funds that are "similar" to hedge funds and private equity funds as being subject to the Rule.[30] The CFTC and the Agencies should limit the scope of covered commodity pools and covered foreign funds to only those commodity pools and foreign funds that are, in fact, similar to hedge funds and private equity funds.

1. Covered commodity pools

We support the recommendations made by SIFMA in its comment letter to the Agencies concerning the factors that should determine which commodity pools should be considered covered funds.[31] Under SIFMA's analysis, covered commodity pools generally would include a commodity pool:

- that engages primarily in trading commodity interests; and
- that does not make a public offering of its securities; and
- whose securities are beneficially owned by no more than 100 persons or exclusively by qualified purchasers (as defined in the 1940 Act); and
- has all of the characteristics of a hedge fund or private equity fund as set out in Annex B of the SIFMA Funds Comment Letter. In the case of hedge funds, these characteristics include that the fund invests in a portfolio of investments; has limited redemption rights; is advised by a manager that earns performance-based compensation; is not subject to day-to-day control by its investors; and is not subject to regulatory restrictions on investment activities, including the use of leverage. In the case of private equity funds, these characteristics include that the fund invests in a portfolio of investments; prohibits investors from withdrawing their interests; is advised by a manager that earns performance-based compensation; is not subject to day-to-day control by its investors; has as its investment purpose generating returns by acquiring unregistered equity or equity-like securities of privately held companies and holding those investment for long-term gain; is, by its terms, in existence for a specified period of time; admits new investors or permits investors to increase their investment in the fund only during an initial start-up period; and is not subject to regulatory restrictions on investment activities, including the use of leverage.

[30] Section 13(h)(2) of the Banking Holding Company Act, as amended by Section 619 of the Dodd-Frank Act (defining the terms "hedge fund" and "private equity fund").

[31] *SIFMA Funds Comment Letter*.

We note that Senators Merkley and Levin express support for the Proposal's definition of "similar fund" to include all commodity pools. However, their letter provides no rationale for this approach other than that commodity pools "could easily be used by banks to engage in proprietary trading."[32] We do not believe that this assertion accords with the plain language of the Volcker Rule's definition of hedge funds and private equity funds or the purpose underlying the restrictions upon covered funds activities. Moreover, it appears to confuse the intended scope of the Volcker Rule's proprietary trading prohibition, which applies to trading of interests in all commodity pools and investment funds, with that of the provisions governing sponsorship of and investment in hedge funds and private equity funds, which are limited to funds similar to hedge funds and private equity funds. We submit that the congressional intent of the funds provisions of the Volcker Rule requires a more limited definition of "similar fund." We urge the CFTC and the Agencies to reconsider the definition of covered funds and revise it to include only those commodity pools that have characteristics and regulatory status that are in fact similar to those of hedge funds or private equity funds.

2. *Covered foreign funds*

The CFTC and the Agencies similarly should limit the scope of the foreign funds that are covered funds to avoid subjecting funds that are publicly offered and subject to substantive local regulation to the Volcker Rule funds provisions. We support the recommendations made by SIFMA, the ICI, the European Fund and Asset Management Association, and the Investment Funds Institute of Canada in their comment letters to the Agencies concerning the exclusion of foreign funds that are not similar to hedge funds or private equity funds from the Volcker Rule.[33] More specifically, we recommend the CFTC and the Agencies consider SIFMA's formulation of a definition of "similar foreign funds," which would define the scope of foreign funds subject to the Volcker Rule.[34] Under this formulation, a foreign fund would be a covered fund if:

- it is engaged primarily in investing, reinvesting or trading in securities or it is engaged in investing, reinvesting, owning, holding or trading in securities and the value of its investment securities exceeds 40% of the value of its total consolidated assets; and

[32] *Merkley-Levin Comment Letter* at 39.

[33] *SIFMA Funds Comment Letter; ICI Comment Letter;* Letter from ICI Global to the Agencies (Feb. 13, 2012), *available at* http://www.ici.org/pdf/12_icig_volcker.pdf; Letter from European Fund and Asset Management Association to the Agencies (Feb. 13, 2012), *available at* http://www.efama.org/index.php?option=com_docman&task=doc_download&gid=1635&Itemid=35; Letter from the Investment Funds Institute of Canada to the Agencies (Feb. 13, 2012), *available at* http://www.federalreserve.gov/SECRS/2012/February/20120216/R-1432/R-1432_021412_105314_542080600395_1.pdf.

[34] *SIFMA Funds Comment Letter.*

- it does not make a public offering of its securities or it is not eligible to make a public offering and is not subject to regulation of its activities or investments; and
- its securities are beneficially owned by no more than 100 persons or exclusively by qualified purchasers (as defined in the 1940 Act); and
- it has all of the characteristics of a hedge fund or private equity fund as commonly understood, as set forth on Annex B of the SIFMA Comment Letter and summarized above; and
- it does not rely on an exemption from the definition of investment company under the Investment Company Act of 1940 other those in Section 3(c)(1) or 3(c)(7) and is not an exchange-traded fund.

III. Responses to CFTC Questions

In the Proposal, the CFTC poses several questions relating to its adoption of Volcker Rule implementing regulations not raised by the Agencies. Our recommendations relating to these questions include the following:

- Supervisory responsibility must be coordinated among the Agencies;
- The Agencies should jointly adopt final Volcker Rule implementing regulations and should seek conceptual consistency with other Dodd-Frank Act rulemaking;
- Repurchase and reverse repurchase arrangements are appropriately excluded from the Volcker Rule; positions financed by these arrangements should similarly be excluded; and
- The CFTC and the Agencies should conduct a through cost-benefit analysis in connection with final Volcker implementing regulations.

We discuss each of these recommendations in more detail below.

A. Supervisory responsibility must be coordinated among the Agencies.[35]

The Proposal seeks comment concerning how the CFTC and the Agencies should allocate supervisory responsibility for purposes of the Volcker Rule and any final implementing regulations. We commend the CFTC for focusing on this important issue.

[35] This discussion responds to question 8.1 in the Proposal.

We strongly believe that to avoid supervisory confusion and the potential for regulatory arbitrage, the CFTC and the Agencies should clearly establish coordination requirements with respect to their interpretive, examination, and enforcement authority under the Volcker Rule.[36] More specifically, the Agencies should delegate to one Agency, preferably the Federal Reserve, ultimate authority to interpret the Volcker Rule and final implementing regulations. This designated Agency may be required to consult with any Agency that has subject matter expertise with respect to the particular products or activities at issue.[37] Examination and enforcement authority should be exercised by the primary regulator of the relevant banking entity, but coordination with other relevant Agencies should be required. When conducting examinations of a banking entity, an Agency should be required to coordinate with any other Agency that has examination authority over a banking entity. Similarly, all Agencies that participated in the coordinated examination process should be consulted before any Agency exercises its enforcement authority to ensure a coordinated enforcement process.

B. The Agencies should jointly adopt final Volcker Rule implementing regulations and should seek conceptual consistency with other Dodd-Frank Act rulemaking.[38]

The CFTC requests comment concerning whether several provisions of the Agencies' joint rule proposal that may not be relevant to CFTC regulated banking entities should be included in the CFTC's final Volcker Rule regulations. We believe that consistency in implementation of the Volcker Rule should be a paramount objective of the CFTC and its sister Agencies. We do not believe that Congress intended the statutory text to be applied differently to different banking entities, or worse – to the same entity. Inconsistency in approach would thus not serve any reasoned legislative intent and would confound compliance efforts by banking entities. We believe that the Agencies should jointly adopt one final set of regulations with one adopting release. Having one joint rule is essential to regulatory consistency and will help avoid the needless costs of developing multiple procedures to achieve what should be a single purpose for banking organizations that must seek to comply with the final Volcker Rule regulations on an enterprise-wide basis.

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[36] *See also SIFMA Prop Comment Letter; SIMFA Funds Comment Letter*; Letter from SIFMA to the CFTC (Apr. 16, 2012).

[37] The CFTC has developed similar arrangements to address situations where it and another federal regulator have overlapping jurisdiction. *See, e.g.*, Memorandum of Understanding Between the Federal Energy Regulatory Commission and the Commodity Futures Trading Commission Regarding Information Sharing and Treatment of Proprietary Trading and Other Information (Sept. 2, 2005), *available at* http://www.cftc.gov/files/opa/opacftcfercmou.pdf.

[38] This discussion relates to questions 14.1, 30.1, 64.1, 87.1, 88.1, 168.1, 168.2, 177.1, 227.1, 296.1, and 302.1 in the Proposal.

We further urge the CFTC, in working with the Agencies, to ensure that, as discussed above, similar concepts receive similar treatment under Volcker Rule regulations and regulations implementing other portions of the Dodd-Frank Act. The CFTC asks whether concepts regarding market making from its swap dealer entities definitional rulemaking should be incorporated into regulations implementing the Volcker Rule. We commend efforts by the CFTC to promote consistency between its Dodd-Frank Act Title VII definitional rules and the joint Volcker Rule regulations. But the CFTC should only do so to avoid conceptual inconsistency, rather than, for example, importing the definition of swap dealer as a proxy for purposes of the market making-related permitted activity. In any case, the Commission should only promote consistency with Title VII in the context of one joint rule.

C. Repurchase and reverse repurchase arrangements are appropriately excluded from the Volcker Rule; positions financed by these arrangements should similarly be excluded.[39]

The CFTC notes that, while the Proposal excludes repurchase and reverse repurchase agreements from the definition of trading account, and thus from the scope of the Volcker Rule, the Proposal does not similarly exclude positions being financed by a repurchase or reverse repurchase agreement. The CFTC asks if the Proposal's approach to these transactions is appropriate and whether the exemption should be expanded to include positions being financed by the arrangement.

As an initial matter, we support the exclusion of positions that arise under repurchase or reverse repurchase arrangements from the definition of trading account. While Senators Merkley and Levin argue that repurchase arrangements should not be excluded from the definition of trading account, and that there is no statutory basis for the exclusion,[40] we must respectfully disagree. First, these agreements are not included in the list of instruments and agreements covered by the statutory definition of proprietary trading. Second, as described in the Proposal, they are not a means through which banking entities effect the short-term sale of securities or seek to profit from short-term price movements in those securities. Rather, as acknowledged in the Proposal, repurchase arrangements are primarily a means of financing, functioning economically as collateralized loans. Loans are not subject to the Volcker Rule. Banking entities use repurchase arrangements to finance a wide variety of activities, including dealing in U.S. Treasuries and in other markets. We do not believe that Congress intended to restrict these core banking activities by subjecting them to the Volcker Rule.

Moreover, as suggested by the CFTC's question in the Proposal, positions being financed by repurchase arrangements also should be excluded from the trading account definition.

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[39] This discussion relates to question 30.2 in the Proposal.

[40] *Merkley-Levin Comment Letter* at 11-12.

These positions often directly support a banking entity in meeting its obligations under a repurchase arrangement. For example, a banking entity engaging in a reverse repurchase agreement may need to purchase positions to meet its delivery obligations under the agreement. If such purchases are covered by the definition of trading account, a banking entity may be unable to meet its obligations under a repurchase agreement. This would limit the type of activity that the Proposal appropriately seeks to exclude from the Volcker Rule.

D. The CFTC and the Agencies should conduct a through cost-benefit analysis in connection with final Volcker implementing regulations.[41]

The CFTC seeks comment concerning the costs and benefits of the Proposal and the CFTC's assessments of those costs and benefits. The CFTC specifically requests comment on the Proposal's effects on market making and liquidity, the costs of borrowing by businesses and consumers, the prices of financial assets and the competitiveness of the U.S. financial services sector. We believe that the Proposal will have significant, negative effects on market liquidity and will harm the ability of businesses and consumers to obtain essential credit, intermediation, and other services from banking entities. The costs of the Proposal, in our view, far outweigh its benefits.[42] Moreover, the Proposal imposes costs that are unnecessary to implement the Volcker Rule. Many of the Proposal's requirements, for example the inclusion of forward contracts as covered financial positions and of all commodity pools as covered funds, exceed the scope of the statutory language and Congress's evident intent.

We refer the CFTC and the Agencies to studies submitted by other commenters, which have assessed the harm to U.S. markets and the U.S. economy that can be anticipated from implementation of the Proposal.[43] The report submitted by IHS CERA, and co-authored by Dr. Daniel Yergin, reviews in detail the potential costs of the Proposal in energy markets (the "Report").[44] The Report concludes that the Proposal would reduce banking entity participation

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[41] This discussion relates to question 348.1 in the Proposal.

[42] We support, and urge the CFTC and the Agencies to follow, the recommendations made in the *SIFMA Prop Comment Letter* regarding the necessity for a thorough cost-benefit analysis to be conducted in connection with final implementing regulations. *SIFMA Prop Comment Letter* at A-123 through A-130.

[43] *E.g.*, IHS Inc., Comments on Volcker Rule Regulations Regarding Energy Commodities (Feb. 13, 2012), *available at* http://www.federalreserve.gov/SECRS/2012/February/20120216/R-1432/R-1432_021412_105313_542080912901_1.pdf; Oliver Wyman, The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity (Feb. 13, 2012), *available at* http://sec.gov/comments/s7-41-11/s74111-237.pdf; Darrell Duffie, Market Making Under the Proposed Volcker Rule (Feb. 16, 2012), *available at* http://www.sec.gov/comments/s7-41-11/s74111-72.pdf.

[44] IHS Inc., Comments on Volcker Rule Regulations Regarding Energy Commodities (Feb. 13, 2012), *available at* http://www.federalreserve.gov/SECRS/2012/February/20120216/R-1432/R-1432_021412_105313_542080912901_1.pdf.

in exchange-traded and OTC energy markets, diminishing liquidity in those markets and resulting in higher commodity prices and higher transaction costs for energy-related products. More specifically, the Report finds that the Proposal could reduce investment in natural gas resources by $7.5 billion per year, "leading to . . . a $0.64 per MMBTU increase in gas prices and loss of 182,000 jobs."[45] Further, the Proposal, by limiting the ability of banking entities to provide hedging services to utilities, could increase power costs by $5.3 billion per year and, by increasing financing and hedging costs, would curtail the development of refining capacity, resulting in higher and more volatile gasoline prices.[46] Oliver Wyman, in a report on the potential effects of the Proposal on market liquidity, finds that the inclusion of forward contracts and other commodity contracts in the Proposal's prohibition on proprietary trading "represents a clear threat to liquidity provided by banking entities."[47] Its report also notes that the extent to which market participants other than banking entities would be available to provide liquidity in commodity markets "during periods of market stress remains highly uncertain."[48]

The Proposal requests comment on the potential costs associated with the compliance program mandated for large banking organizations. The Proposal mandates the application of up to seventeen metrics daily at a variety of points in a banking entity's trading hierarchy and requires monthly reporting of metrics calculations, despite the procedural complexity in generating the regulatory reports. Written policies and procedures are required for each trading unit, resulting in duplication of efforts and other inefficiencies. The cost burden inherent in complying with these and the other elements of the Proposal's compliance standards will be substantial, including both significant foreseeable costs and those that were not adequately contemplated by the Proposal.[49]

We believe that the cost-benefit analysis conducted by the CFTC and the Agencies in connection with the Proposal is insufficient.[50] We urge the CFTC and the Agencies to engage in

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[45] *Id.* at 7-8.

[46] *Id.* at 8.

[47] Oliver Wyman, The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity (Feb. 13, 2012) at 28, *available at* http://sec.gov/comments/s7-41-11/s74111-237.pdf.

[48] *Id.*

[49] For example, a trading unit engaged in trading activity in reliance on a permitted activity exemption would need to calculate quantitative metrics and report to the CFTC and the Agencies based on the whole of its trading activities – including trading activities outside the scope of the Volcker Rule.

[50] Requirements for the CFTC to conduct a cost benefit analysis include those under the Regulatory Flexibility Act, the Small Business, and Executive Orders requiring federal agencies to conduct cost-benefit analyses in connection with rulemaking. Although the Executive Orders do not apply to the CFTC as an independent agency, the CFTC has indicated that it will seek to engage in the types of cost-benefit analyses required (...continued)

a thorough cost-benefit analysis consistent with the CFTC's policy and legal requirements before issuing final Volcker Rule guidance or implementing rules.

IV. Conclusion

The FIA appreciates the opportunity to provide the CFTC and the Agencies with its comments and recommendations on the Proposal. Given the significant concerns expressed by the FIA and many other commenters regarding the approach taken by the Proposal and the potential significant negative effects of the Proposal on U.S. markets and the U.S. economy, we urge the CFTC and the Agencies to reconsider their approach to implementing the Volcker Rule.

We would be happy to discuss our recommendations further with the CFTC and its staff, and stand ready to be of assistance to the CFTC and the Agencies as they move forward on Volcker Rule implementing regulations. Please direct any questions about our comments and recommendations to Barbara Wierzynski, Executive Vice President and General Counsel, at 202-466-5460.

Sincerely yours,

Walt L. Lukken

Walter L. Lukken
President and Chief Executive Officer

Cc: The Hon. Gary Gensler, Chairman
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Scott O'Malia, Commissioner
The Hon. Mark Wetjen, Commissioner
Dan M. Berkovitz, General Counsel
Office of the Comptroller of the Currency
Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System
Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation
Elizabeth M. Murphy, Secretary, Securities and Exchange Commission

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(continued...)

under the Orders. CFTC, Reducing Regulatory Burden; Retrospective Review Under E.O. 13563, 76 Fed. Reg. 38,328 (June 30, 2011), available at http://www.gpo.gov/fdsys/pkg/FR-2011-06-30/pdf/2011-16430.pdf.