

Electronic Mail and Overnight Mail

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Board of Governors of the Federal Reserve System
Attention: Jennifer J. Johnson, Secretary
20th Street and Constitution Avenue NW.
Washington, DC 20551

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

Office of the Comptroller of the Currency
250 E Street SW.
Mail Stop 2-3
Washington, DC 20219

Securities and Exchange Commission
Attention: Elizabeth M. Murphy, Secretary
100 F Street NE.
Washington, DC 20549

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

Our ref 0010023-0025501 NY:13363313.6

February 13, 2012

Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Proposed Rule; 76 Federal Register 68846; November 7, 2011; Joint Notice and Request for Comment; OCC: Docket ID OCC-2011-14; FRB: Docket No. R-1432 and RIN 7100 AD 82; FDIC: RIN 3064-AD85; SEC: File Number S7-41-11; CFTC: RIN 3038-AD05.

Ladies and Gentlemen:

Allen & Overy respectfully submits this letter in response to the request for comment on the proposed rule on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (the **Proposed Rule**) jointly issued by the Office of the Comptroller of the Currency (the **OCC**), Board of Governors of the Federal Reserve System (the **Board**), Federal Deposit Insurance Corporation (the **FDIC**) and Securities and Exchange Commission (the **SEC**)¹ and the largely identical proposed rule on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and

¹ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (**Proposed Rule**), 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011) (to be codified at 12 C.F.R. pts. 44, 248 & 351, 17 C.F.R. pt. 255).

Relationships with, Hedge Funds and Covered Funds as issued by the Commodity Futures Trading Commission² (the **CFTC**, and, together with the OCC, the Board, the FDIC and the SEC, the **Agencies**). The Proposed Rule would implement Section 619 (**Section 619**) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the **DFA**, and Section 619 thereof, the **Volcker Rule**).³ We welcome the attention of the Agencies to the issues raised below and we appreciate the opportunity to provide comments.

A cornerstone of the global regulatory response to the financial crisis, as outlined by G-20 leaders in Pittsburgh in September 2009, is the move to clear standardized derivatives contracts through clearinghouses; market participants broadly agree that clearinghouses that are designed to manage risk effectively can meaningfully reduce counterparty and systemic risk. However, the complex risk characteristics of such market utilities mean that clearing derivatives transactions safely and efficiently presents unique challenges that are different from those arising when clearing futures contracts or securities.

In our capacity as counsel to global financial institutions and clearinghouses we are privileged to have assisted in their efforts to design clearing systems and rules that are fit for this purpose and "can reduce systemic risk in financial markets."⁴ Our experience in the area of derivatives clearing covers credit derivative transactions (both single name and index), foreign exchange transactions and interest rate swaps. Our work spans the United States, Europe and Asia.

This letter is submitted to express our concern that the Proposed Rule may have a material adverse impact on the global initiatives to promote central clearing. Many clearing members and their affiliates will fall within the Proposed Rule's definition of "banking entity" and we anticipate that many derivatives transactions subject to mandatory or voluntary clearing will be "covered financial positions."

The arguments put forth below should be read in harmony with previously submitted and future comment letters by the Institute of International Bankers, the Securities Industry and Financial Markets Association, the International Swaps and Derivatives Association and other industry groups including those represented by our firm. In particular, please note that the concerns they seek to express about the broad implications and unintended extraterritorial consequences of the Proposed Rule for the basic functions of modern banks as financial intermediaries and liquidity providers both in the United States and abroad form the backdrop to many of the issues identified herein.

1. EXECUTIVE SUMMARY

The legislative intent of the Volcker Rule, as enunciated by Congress, is to "reduce the scale, complexity and interconnectedness" of banks "now actively engaged in proprietary trading."⁵ As noted by the Senate the "prohibitions and restrictions" on proprietary trading "are intended to limit threats to the safety and soundness of the [financial] institutions" and "to limit threats to financial stability."⁶ Consistent with the G-20 commitments, the DFA mandates the clearing of swaps and security-based swaps.⁷ We are therefore certain that it was not Congress' intention that the Agencies limit the ability of

² Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships [sic] with, Hedge Funds and Covered Funds, 77 Fed. Reg. [●] (proposed [●], [●], 2012) (to be codified at 17 C.F.R. pt. 75).

³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620 (July 16, 2010) [hereinafter **Dodd-Frank Act**].

⁴ CPSS-IOSCO May 2010 consultative report on "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives Clearinghouses", the report is available at: www.bis.org/publ/cpss89.pdf?noframes=1. See page 32.

⁵ S. Rep. No. 111-176, at p. 9 (2010).

⁶ Id at p. 90.

⁷ Dodd-Frank Act § 723(a). Clearing [for Swaps]; Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44464 (final, July 26, 2011) (to be codified at 17 C.F.R. pts. 39 and 140); Dodd-Frank Act § 763(a); Clearing for Security-Based Swaps. Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 75 Fed. Reg. 82490, (proposed, December 30, 2010) (to be codified at 17 C.F.R. pts. 240 and 249).

clearinghouses to develop sound risk management practices, or the ability of financial institutions to comply with those practices or facilitate their clients' move to clearing in furtherance thereof. We are concerned, though, that, in promulgating the Proposed Rule as drafted, the Agencies may be doing just that.

The Agencies request "comment regarding the proposed clarifying exclusions and whether any other types of activity or transactions should be excluded from the proposed definition of trading account for clarity."⁸ In particular, the Agencies request in question 43 of the Proposed Rule release whether additional clarifying exclusions are warranted beyond the exclusion from the definition of "trading account" of positions taken by derivatives clearing organizations and clearing agencies.⁹ The exclusion from the definition of "trading account" of positions taken by derivatives clearing organizations and clearing agencies is proposed because "these types of transactions do not appear to be of the type intended to be covered by the statutory definition of trading account, as the purpose of such transaction is to provide a clearing service to third parties and not to profit from short-term resale or short-term price movements."¹⁰

For the same reasons, we urge the Agencies to exclude all clearing-related activities from the definition of "trading account."

As demonstrated below, we believe that certain clearing-related activities may currently fall within the definition of trading account and that it is uncertain whether any currently proposed exclusions would apply. The developing nature of the derivatives clearing industry and extraterritorial scope of the Proposed Rule means that our examples are of necessity incomplete and that a broad exclusion is required.

2. OBSTACLES TO CLEARING

Two issues we propose to cover below are:

- (1) Risk management; and
- (2) Facilitating access to clearing.

2.1 Risk Management

(a) Default Management

Pursuant to the DCO Core Principles, clearinghouses are required to "adopt rules and procedures designed to allow for the efficient, fair and safe management of" a clearing member's default.¹¹ The default management process is primarily aimed at reducing the clearinghouse's exposure to the open positions of a defaulted clearing member (or its customers). While clearinghouses take different approaches, there are three general features common to any such process:

- (i) Porting, whereby the defaulted clearing member's customer positions and margin are transferred to another clearing member;

⁸ See Proposed Rule release at 68863.

⁹ Id.

¹⁰ See Proposed Rule release at 68863.

¹¹ Derivatives Clearing Organization General Provisions and Core Principles (the **DCO Core Principles**), 17 C.F.R. § 39.16(a).

- (ii) Hedging, where the clearinghouse looks to clearing members and third parties to enter into risk-reducing transactions and to flatten the market risk associated with the house positions of the defaulted clearing member and the customers positions that have not been ported; and
- (iii) Unwinding the defaulted clearing member's house and, to the extent not ported, customer positions, together with any hedging transactions.

The third step in the process outlined above may involve the allocation of the defaulted clearing member's open positions to non-defaulted clearing members, its affiliate or third parties, either pursuant to a mandatory auction process¹² or, less desirably, through forced allocation of portfolios such that clearing members are forced to take on the open positions of the defaulted clearing member. Clearinghouses are required under the DCO Core Principles on "Default Procedures" to set out such process in their rules.¹³

Participation in the default management process of the clearinghouse is of key importance. In doing so, entities will either be complying with the express requirements of the clearinghouse or contributing to risk-reducing techniques designed by the clearinghouse. Each of these activities are, unfortunately, likely to fall within the express prohibition of the Proposed Rule as drafted, without having the benefit of any exclusion. However, an exclusion that is limited to the activities mandated or expressly permitted by the clearinghouse would not itself be adequate. In order to contribute meaningful prices, bidders and hedgers will need to be able to manage the risks that are off-loaded to them by the clearinghouse, therefore the clarifying exclusion would need to include all activities that are related to the clearing function.

We note that preferential capital treatment under the proposed Basel III capital rules¹⁴ in respect of a party's exposure to a clearinghouse is available only where the clearinghouse in question follows the proposals in the CPSS-IOSCO Report.¹⁵ To the extent that, due to the conflicting requirements of the Proposed Rule, a clearinghouse cannot be confident that market participants are able to make meaningful contributions to their risk mitigating activities, this may ultimately have capital consequences for clearing members and their customers in addition to more serious systemic risk implications.

(b) Daily risk management

Similar concerns with the Proposed Rule apply in connection with certain day-to-day risk management tools employed by clearinghouses.

(i) Self-Referencing Transactions

One specific example relates to credit default swaps (CDS) and applies where the seller of protection under a CDS sells credit protection on itself. These transactions can arise, for example, where an entity succeeds to the obligations of another following a corporate merger. In order to reduce the potential credit and legal risks associated with such position,

¹² This method of allocation is supported by the CPSS-IOSCO Consultative Report on Principles for Financial Market Infrastructures (the **CPSS-IOSCO Report**), which suggests that a clearinghouse "may need to consider requiring participants to agree in advance to bid on the defaulted participant's portfolio." The report is available at <http://www.bis.org/publ/cpss94.pdf>.

¹³ DCO Core Principles, 17 C.F.R. § 39.16(c)(2)(ii).

¹⁴ Regulatory Capital Proposed Rule Text on the Capitalization of Exposures to Central Counterparties, Basel Committees, Annex 4. The proposed rule is available at <http://www.bis.org/publ/bcbs206.pdf>.

¹⁵ Basel Committee on Banking Supervision, Consultative Document on Capitalisation of Bank Exposures to Central Counterparties, 25 November 2011, at 3. The report is available at <http://www.bis.org/publ/bcbs206.pdf>.

clearinghouses such as ICE Clear Credit U.S., ICE Clear Europe and the CME Group, have the right to require clearing members to participate in mandatory auctions to unwind such positions. Under the Proposed Rule as drafted, many trades formed in such an auction would be impermissible proprietary trades.

(ii) Trade Crossing

A further instance in which the Proposed Rule might interfere with risk management is the mechanism employed by certain clearinghouses to incentivize members to provide accurate end-of-day prices for open positions. In order to ensure the accuracy of this price discovery process, the rules governing such clearinghouses may require "firm bids" from clearing members and even require them to enter "forced trades" to be crossed with another clearing member's bid. This mechanism is crucial in promoting the integrity of the price-submission process and price transparency within the financial system. Notably, the SEC found such a mechanism important enough to issue an exemption from the requirement to register as an exchange in connection with such activity to clearinghouses such as ICE Clear Credit U.S. and ICE Clear Europe.¹⁶

2.2 Facilitating access to clearing

(a) Clearing of Customer Transactions

There are several ways in which non-clearing member entities that may be required to clear or may elect to clear derivatives transactions can be given access to the benefits afforded by clearing.¹⁷ One is known as the agency model, in which the clearing member acts as agent for an undisclosed customer which acts as principal to the transaction with the clearinghouse. The other is the principal model in which a clearing member enters into two trades as a principal: one with its customer and the other with the clearinghouse. Absent an exclusion for this activity, it is conceivable that these principal transactions could fall within the definition of "trading account." A further example is the indirect clearing model in which customers clear transactions through a foreign broker for which the clearing member acts as agent. As the industry moves to develop greater protections for the assets of these customers, particularly outside of the United States, we expect other models to develop. In each of these cases, clearing members will take some form of principal risk in relation to the cleared positions as they guarantee the performance of their clients.

(b) Collateral Transformation

The provision of collateral transformation services to customers will in many cases be crucial to a customer's access to a clearinghouse and is a standard feature of the current clearing structure. Such service involves an entity, which may be an affiliate of the relevant clearing member, for a fee, converting customer collateral that is ineligible for onward posting to the clearinghouse into eligible collateral. Pursuant to the DCO Core Principles, a clearinghouse "shall limit the type of assets it accepts as initial margin to those that have minimal credit, market and liquidity risk,"¹⁸ meaning that sourcing eligible collateral will be a key concern. Collateral transformation services ensure customers' access to the clearinghouse and offer an efficient means for customers to meet their margin posting obligations.

¹⁶ Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of "Security" to encompass Security-Based Swaps, and Request for Comment, Release No. 34-64795 (SEC, July 1, 2011) at p. 24.

¹⁷ Due to the extraterritorial implications of the Volcker Rule clearinghouses' jurisdictions and regulatory regimes outside the United States must be taken into consideration by the Agencies.

¹⁸ DCO Core Principles, 17 C.F.R. § 39.13(g)(10).

Collateral transformation services take a variety of forms, some of which might fall outside the prohibition on proprietary trading or benefit from a proposed exclusion. However, customers seeking access to clearing and clearing members seeking to provide it would benefit from a specific exclusion for collateral transformation services so that such facilities can be offered without fear of falling foul of the Proposed Rule.

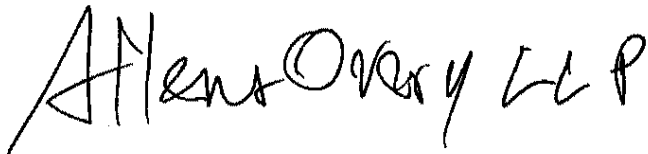
3. RECOMMENDATIONS

As we note in this letter, the development of the architecture for the clearing of derivatives ongoing. While it seems self-evident that the activities outlined above are not intended to be barred by Section 619, it remains unclear whether these activities would necessarily fall within any of the exclusions in the Proposed Rule. In addition, it is important to remember that each class of swap is different and poses its own unique challenges when providing for the clearing of such products. In urging the Agencies to exclude clearing related activities from the definition of "trading account", we would caution against crafting an exclusion that is overly prescriptive and narrow. Instead, the Agencies should allow a broad exclusion for clearing related activities, which should, as described above, include ancillary activities. An overly narrow and prescriptive exemption would lead clearing members to dedicate significant resources to compliance functions that would add little to the protection of the financial system compared to building actual risk-reducing processes. For these reasons, a broad exclusion would provide flexibility for clearinghouses and clearing members in designing risk management systems and in managing their risk, which would benefit the financial system as a whole. For the foregoing reasons we respectfully request that the Agencies re-propose the Volcker Rule implementing regulations by including a clarifying exclusion for all activities related to or incidental to central clearing.

* * *

We would be pleased to provide further information or assistance at the request of the Agencies or their staffs. Please do not hesitate to contact Deborah North, (212) 610-6408, John Williams, (212) 756-1131 or Douglas Landy, (212) 610 6405, at Allen & Overy LLP if you should have any questions with regard to the foregoing.

Yours faithfully,

A handwritten signature in black ink that reads "Allen & Overy LLP". The signature is written in a cursive, flowing style.

Allen & Overy, LLP