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Comments on the Proposed U.S. Volcker Rule

Japanese Bankers Association

The Japanese Bankers Association (JBA) is an industry association of 142 Japanese banks and 46 non-Japanese banks with operations in Japan. The viewpoints presented herein reflect the consensus of Japanese member banks.

JBA appreciates the opportunity to comment on the Proposal, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds,* released November 7, 2011, by the Federal Reserve Board (FRB) [Docket No. R–1432, RIN 7100 AD 82], the Office of the Comptroller of the Currency (OCC) [Docket No. OCC–2011–0014, RIN 1557–AD44], the Federal Deposit Insurance Corporation (FDIC) [RIN 3064–AD85], and the Securities and Exchange Commission (SEC) [Release No. 34–65545, File No. S7–41–11, RIN 3235–AL07].

We hope that our comments below will assist the U.S. Agencies in finalizing the rule going forward.

【General comments】

It is our understanding that the purpose of implementing the Volcker Rule is to reduce the likelihood of the re-occurrence of a financial crisis as well as to protect investors and depositors. Preventive measures may include limits on speculative investing by deposit-taking banking entities.

However, extreme restrictions or prohibitions of such activities could constrict banking business and obstruct financial intermediary functions of those depository institutions.

Furthermore, the Volcker Rule, to be introduced in the US, is expected to have a considerable impact on the revenues and organizational structures of foreign banking entities because of its wide application. Thus, strengthening the regulations of a single country could result in the world financial system as a whole becoming less stable and impeding the global economy’s recovery.

In particular, <u>the Volcker rule’s 1) extraterritorial effect; 2) non exemption of non-US sovereign debt; and 3) non exemption of foreign exchange forwards and currency swaps could cause the global economy to deteriorate by squeezing sovereign debt market</u>

transactions around the world and reducing market liquidity resulting from a shortage of USD supply. We believe that the domestic regulations of the US should not encourage instability of the international financial system.

Furthermore, this rule should be drafted in such a way that contradictions and inconsistencies do not arise vis-à-vis global efforts to prevent the re-occurrence of a financial crisis, such as SIFI regulations and Basel III regulations.

Appropriate coordination between US regulatory authorities and the regulators of other foreign countries should take place on these issues.

【Specific comments】

Coverage of the proposed rules

The implementation of the rule should in principle respect the provisions of the applicable laws of the home countries of foreign banking entities. Since new definitions in the proposed rule (eg., *trading accounts*) would be added to the regulatory frameworks in the home countries of foreign banking entities subject to the new rule , extremely complex procedures would be required for those foreign banking entities to comply. At the same time, costly systems investments would also be necessary. [1] Also, it should be stated clearly that an entity with a foreign banking entity as its majority shareholder would be treated as a foreign banking entity even if a US banking entity holds partial interest in that entity.

It is not necessary to cover all banking entities registered as swap dealers and their affiliates under the new rule. In the banking entities, credit-related accounts that have no relation to trading would be subject to the rule, which would have a huge impact. At the same time, the rule could unintentionally restrict inorganic strategic investments of companies registered as swap dealers. Therefore, the provision requiring all banking entities and their related companies registered as swap dealers to be covered by the rule should be deleted. (Q22)

○ Prohibition on proprietary trading

1. Definition of *proprietary trading*

(1) Clarification of definition of *proprietary trading* (Q18)

The following items should be explicitly excluded from the definition of proprietary

[1] Specifically, the following problems may arise. 1) Because the scopes of the definition of *trading account* in the proposal and in US GAAP are different, even legal trades could be considered illegal. For example, AFS securities are defined as non-HTM securities or non-trading securities in US GAAP. Also, under the proposal, a rebuttal would be required even for an AFS if it is sold within 60 days (regardless of initial holding intent). Take for example a non-US sovereign bond (eg., a euro bond) purchased as an AFS with a banking account that is sold within 60 days because credit conditions have deteriorated or because the price has fallen, for which the above-noted rebuttal is denied. Not only would this be denied as a banking account transaction in terms of financial accounting, it could also be a violation of the law under the Volcker Rule. Also, (2) the hedging-related prima facie evidence process in this proposal and the prima facie evidence process used for hedging in financial accounting differ. Thus, the banking entity's side would be required to undergo two types of prima facie evidence processes.

trading:

1) Hedge accounting-related trades for the purpose of ALM and bond investments conducted in banking accounts

Trade positions the purposes of which are not for profiting from short-term market movements and bond trades made for investment purposes that had to be closed within 60 days due to sudden market changes, despite initially being intended as a long-term holding, should be excluded, and, of course, should not be subject to reporting requirements. .

Furthermore, the classification of accounts should be in accordance with the applicable laws of the home country of the banking entity. Requirements that apply to hedging transactions should be coordinated between US and Japanese regulators so that Japanese banking entities can be in conformance with Japanese accounting standards. To fulfill US and Japanese rules concurrently, preparations for compliance (or administrative requirements), system development, and an accounting reporting structure would be necessary; and these could cause operations to shrink temporarily.

2) Agent, Broker, or Custodian for an unaffiliated third party

Not only acting as agent, broker, and custodian activities for unaffiliated third parties, but also acting as agent, broker, or custodian for affiliates should be excluded. (Q14)

3) Derivatives and commodities futures that require variation margins

Derivatives and commodities futures transactions subject to variation margin typically include not only CSA (Collateral Support Annex) for general derivatives transactions that are becoming more common, but also trades with central clearing parties. Variation margins were introduced for the purpose of risk management, so a ban across the board on related activities could unfairly reduce the liquidity of trades. (Q18)

(2) Rebuttable Presumption

The following clause should be deleted: "*An account shall be presumed to be a <u>trading account</u> if it is used to acquire or take a covered financial position, other than a covered financial position described in paragraph §_.3 (b) (2) (i) (B) or (C) of this section, that the covered banking entity holds for a period of sixty days or less, unless the covered banking entity can demonstrate, based on all the facts and circumstances, that the covered financial position, either individually or as a category, was not acquired or taken principally for any of the purposes described in paragraph (b)(2)(i)(A) of this section*." Classifications of trading and banking accounts differ country by country, and they are reviewed by regulators in the respective countries. Further, requiring foreign banking entities to rebut to the US regulatory authorities would result in a higher cost than is necessary and would not be appropriate. (Q23)

Banking entities have multiple options in making hedge transactions, which in itself reduces specific risks, or minimizes the size of the positions that arise from customer transactions. Therefore, for hedging activities, holding periods should not be uniformly regulated; rather, it is more rational to promote ‘enhanced risk management’ by, for example, setting ‘risk tolerance and allowable position limits’ calculated from adequate required capital. (Q23)

If setting a holding period is unavoidable, the period should be consistent with US financial accounting guidelines (related to securities investment trading) in order to avoid confusion. A maximum holding period of 30 days or less is adequate. (Q28)

2. <u>Definition of *covered financial position*</u>

(1) Foreign exchange forwards and currency swaps

Foreign exchange transactions other than spot foreign exchange transactions should not be included in the definition of covered financial position. Covering such transactions in the Volker Rule would increase market liquidity risk and instability, therefore causing adverse effects to the economy. (Q46)

Above all, <u>foreign exchange forwards, non-deliverable forwards (NDF) and currency swaps are widely used for foreign currency funding or hedging of assets denominated in a foreign currency, and are a core component of the commercial banking business</u>. These transactions are distinguished from commodities transactions in that they are often backed by non-financial trades worldwide; therefore, they should not be prohibited as derivatives transactions. (Q52, 53) The US Secretary of the Treasury does not treat foreign exchange forwards as derivatives in the Dodd-Frank Act, as noted in Footnote 126; therefore, it would be appropriate to treat these transactions in the same manner. (Q55)

In principle, derivatives transactions covered in this rule should defer to the applicable laws and/or regulations of the home country. (Q54)

In the proposed rule debt securities are covered, although loans are not within the scope of the covered financial position. Debt securities, like loans, should also be excluded from the covered financial positions. Both loans and debt securities are negotiable, and they have similar economic effects. Of course, neither is intended for short-term resale and there is no reason to treat them separately. In some cases, banking entities are obliged to hold debt securities from long-term customer relationships. Accordingly, it is necessary to exclude debt securities from covered financial position in order to maintain the stability of the overall financial system. (Q46)

(2) Liquidity management

As proposed, positions acquired or taken for liquidity management purposes should be excluded from the scope of prohibited proprietary trading. (Q34, 35, 40)

The requirement to develop and use a documented liquidity management plan for allowing exemptions to the rule for liquidity-management positions should be flexible in order to cope with sudden changes in the environment. (Q33)

In addition, the fourth requirement to exempt positions for liquidity management purposes from the scope of prohibited proprietary trading (i.e., *limiting any position acquired or taken for liquidity management purposes, together with any other positions acquired or taken for such purposes, to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations, as estimated and documented pursuant to methods specified in the plan*) should be deleted. Valuation based on deviation from the required amount for normal operations may restrict the funding operation to the funding plan and funding needs that were prepared beforehand. This could ultimately weaken financial institutions' ability to respond to unexpected financial market conditions in terms of funding management. (Q36, 38)

3. <u>Permitted activities as exceptions</u>

(1) Underwriting activities

Of the seven criteria for exceptions to the prohibition of proprietary trading, we believe that the fifth should be eliminated, or the wording should be changed to, for example, '*underwriting activities of the banking entity with respect to the covered financial position must be designed <u>to meet the near-term demands of clients, customers and counterparties.</u>*' (Q65)

Furthermore, we believe that the clause that requires being *'related to the hedging of such covered financial position'* in the sixth requirement should be deleted. The requirement would lead to greater caution in underwriting in the primary market and could increase the risk of insufficient bids in sovereign debt auctions. (Q67)

For permitted activities, underwriters are required to meet the criterion of *not to exceed the reasonably expected near-term demands of clients, customers and counterparties*. While some markets can forecast near-term customer demand to some degree through comprehensive assessment based on interviews with customers, past sales histories, and market conditions, other markets are more difficult because short-term demand cannot be forecasted accurately. Therefore, the requirement not to exceed customer demand should be deleted. (Q73)

Whether to underwrite and/or retain securities is determined at individual banking entities from customer relationships and their credit assessments. Therefore, the requirement to disclose securities retained in connection with underwritings is unnecessary. Underwriting in itself, like lending, is one of the important financial functions of banking entities. Determinations of whether to underwrite or not are made based on the credit assessments at individual banking entities, and we believe that the potential side effects of an additional requirement related to underwritings solely for regulatory purpose could cause greater stress on market financial functions . (Q79)

(2) Permitted market making-related activities

The determination criteria of whether or not certain activities fall within the scope of market making-related activities should be simplified and clarified. Not only is there a heavy validation and reporting burden for each participant, but we are also concerned about the effectiveness of such efforts. (Q81-85)

We seek a clear definition of *customer*. In particular, it should be clearly noted that interbank participants could be customers for interbank market makers. (Q80-86, 99)

Rather than regulating activities and positions that are associated with market making-related activities, the aim should be to improve risk management methods by, for example, setting risk allowance positions calculated from the required capital commensurate with market making-related activities. It would be difficult for banking entities to find effective market making-related activities unless some flexibility in terms of risks and positions held by banking entities is permitted. (Q80)

1) Seven required criteria for permitted market making-related activities

The required criteria for permitted market making-related activities should be readdressed. The specific issues are listed below.

- ✧ Criterion §_.4(b)(2)(iii): The definition of *'the reasonably expected near-term demands of clients, customers, and counterparties'* is unclear. It would be difficult to meet the requirement of *the reasonably expected near-term demand* for banking entities as proposed. (Q87)
- ✧ Criterion §_.4(b)(2)(v): It is difficult to determine whether the revenue comes from bid/ask spreads or changes in the value of covered financial positions. (Q87, 96)
- ✧ Criterion §_.4(b)(2)(vii): This criterion could cause liquidity to decline in the secondary market, so the criterion should either be eliminated or included as reference information to identify permitted market making-related activities. (Q87)
- ✧ Fulfilling the seven proposed criteria at the same time could cause market instability. Though the proposed rule requires the delta as a risk indicator to be designed so that it does not exceed reasonably expected near-term demand, this requirement would result in market making functions likely to be inadequate when unexpected events occur or when transactions exceeding rational forecasts arise. As a result, markets could be destabilized. (Q89, 94)
- ✧ It is difficult to differentiate risk-taking activities related to market making and arbitrage activities. Arbitrage trading activities that promote market liquidity and

price transparency should not be prohibited only because these activities are not permitted market making-related activities. (Q91, 94)

- ✧ At present, profits from market making-related activities are extremely small. Furthermore, if the proposed requirements are made, market making-related activities would not be feasible in terms of cost effectiveness and would diminish. In due course, customers would be adversely impacted in terms of liquidity shortages and price volatility. Accordingly, individual banking entities should be allowed some discretion in setting delta. (Q80)

2) Market making-related hedging

It would be appropriate to exempt market making-related hedging from the rule. However, criteria for market making-related hedging should not be as strict, similar to the discussions of permitted risk-mitigating hedging. Market making-related activities are conducted as risk-taking activities based on forecasts of market movements and/or hedging activities for continuous price offerings and applying the same criteria as permitted risk-mitigating hedging could cause liquidity to decline in the secondary market. (Q98)

If criteria similar to that of permitted risk-mitigating hedging are applied, the criteria §_.5 (b)(2)(ii),(iii), (iv) and (v) should be reassessed because of immobility and ineffectiveness for such transactions. (Q98)

3) Proposed Attachment B - commentary regarding identification of permitted market making-related activities

When the activities' main purpose is market making-related activities and the ratio of customer profit to overall profit, i.e. the activities are mainly dealing with instruments with small bid-to-offer margins, it should not be regarded as proprietary trading. (Q177)

Restricting permitted market making-related activities will reduce the number of investors underwriting on the other end of the transactions significantly and will lead to a decline in liquidity. For example, it is not realistic to uniformly restrict the heavily-traded foreign exchange markets in the same manner as small commodities markets. (Q179)

The six criteria for permitted market-making transactions are complex. While the burden for analyzing the breakdown of profits and *reporting is extremely heavy, the effectiveness of the proposed indicators* is uncertain. Considering the nature of the transaction, qualitative criteria should be used instead of quantitative measurements. (Q184, 185, 186)

(3) Permitted risk-mitigating hedging activities

The clause *'if the predicted performance of a hedge position during the period that* *the hedge position and the related position are held would result in a banking entity earning appreciably* <u>*more profits on the hedge position than it stood to lose on the related position*</u>*,* <u>*the hedge would appear likely to be a proprietary trade*</u> *designed to result in profit rather than an exempt hedge position'* should be eliminated.

Banking entities use credit default swaps (CDS) to hedge against default risk of bonds and loans, and CDS market value gains/losses often temporarily exceed the market value gains/losses of bonds and loans that are hedged against. Banking entities must not be deprived of important hedging methods. (Q105) Above all, when credit risk of loans, which are not subject to market valuation, is hedged using CDS, which are subject to market valuation, the assessed profit is expected to arise only from the CDS position. We would like to confirm that such hedges are valid hedges and are permitted.

1) Seven criteria for permitted risk-mitigating hedging activities

We agree with the exemption of hedge trading from the prohibition. However, the regulation as currently proposed could reduce the operability of hedge trading and cause market liquidity to decline. Therefore, criteria for permitted risk-mitigating hedging activities should be reassessed as described below. (Q105-107)

- ✧ §_.5(b)(2)(i): The criteria should be reviewed. Depending on the type of hedged transaction, the banking entity would incur substantial burdens and system investment burdens.
- ✧ §_.5(b)(2)(ii): The criteria should take into consideration that as hedging activities are made under constantly changing positions and market conditions, it is difficult to specify the hedged items in advance in the limited time available.
- ✧ §_.5(b)(2)(iii): The criteria is unnecessary because a requirement to be '*reasonably correlated'* is not effective. The correlation between hedged items and hedges may become weak depending on market conditions, and banking entities could incur substantial administrative burdens and system investment burdens in order to fulfill this requirement, depending on the type of the hedging transaction. Therefore, this requirement should be revisited. For example, we propose that when the essential risk of a hedged item appears to be identical to the risk purpose of the hedging, being *'reasonably correlated'* should be presumed.
- ✧ §_.5(b)(2)(iv): The criteria should take into consideration that hedging transactions could possibly be made in advance against positions that do not exist when the hedge is first made.

2) Documentation requirement

The current proposal would require that permitted activities like market making-related activities and risk-mitigating hedging activities be documented, and banking entities with gross trading assets and liabilities of USD5 billion or more would have to submit 17 quantitative reports every month. The Volcker Rule is no more than one part of the Dodd-Frank Act, and banking entities already are facing substantial reporting burdens, including those required by other derivatives rules under the Dodd-Frank Act. Banking entities would incur substantial new burdens from such qualitative and quantitative reporting in terms of personnel, infrastructure, and investment cost, and at the same time the difficulty of the qualitative reporting is extremely high. The administrative costs could exceed profits in some cases, and this would compress banking operations. Furthermore, foreign banking entities must manage operations in line with derivatives regulations in their home countries, and we are concerned that the burden would be too great for the limited resources of many foreign banking entities. (Q110)

The subject of documentation for risk-mitigating hedging activities should be clarified based on instrument attributes. (Q114)

The proposed rule requires detail descriptions for derivatives market-making businesses that execute dynamic hedging. Since these transactions frequently require fine adjustments, this will impose a significant burden on the banking entities. Therefore, in some instances, it should be recognized that documentation is not needed, for example by clarifying the functions of the trading desk. Or ex-post documentation should be allowed. (Q106, 114)

(4) Other permitted trading activities

1) Trading in non-US government obligations

Under the proposed rule, only US government obligations, obligations of US government-sponsored agencies, and obligations of local government-like state obligations would be treated as exemptions. However, considering the objective of promoting US financial stability and ensuring the stability and soundness of the banking business—if the rule is approved as proposed, the possibility of cultivating investment fund flows to be concentrated in the US cannot be eliminated. Disequilibrium and unfairness could cause global financial turbulence, and the destruction of the supply-demand balance in the bond market could result in an unstable market environment around the world. (Q122)

Therefore, for example, <u>foreign government bonds that meet some conditions (government bonds eligible as FRB collateral, sovereign bonds issued by G20 countries, highly liquid listed instruments, etc.), or derivatives transactions with those as underlying assets should also be exempted</u>. (Q122)

2) Derivatives transactions with US government bonds (including US government bonds, agency bonds, and local government bonds) as underlying assets

Derivatives transactions with US government bonds as underlying assets should be allowed, because it is critical to maintain the liquidity and size of the market when banking entities utilize derivatives transactions with underlying assets including US government bonds for the purpose of hedging the interest rate risk of the portfolio. (Q55, 121)

It must be noted that the permitted hedging transactions are too strict and banking entities would incur huge responsibilities and costs for monitoring (Q121).

3) Exchange trades

Exchange trades, including consignments to US banking entities, should be permitted because these contribute to the stability of the spot trading market, the liquidity of which must be ensured. (These should be exempted from prohibited proprietary trading.) Note that exchange trading is ensured daily by clearing margins in light of future market movements, and because of the high liquidity of the standardized transactions, these should be considered low-risk assets or low-risk transactions. (Q117)

4) Transactions with affiliates and subsidiaries and related to hedging activities

Transactions with affiliates and subsidiaries and related hedging activities are a type of market making-related activity or risk mitigating hedging activity, so these transactions should be exempted from the rule. (Q87, Q102)

Transactions involving a counterparty with a foreign headquarters or branch outside the US (eg., transactions between a Japanese banking entity's headquarters and its New York branch) should clearly be permitted, as well as transactions among domestic US branches (the New York branch and Los Angeles branch of a Japanese banking entity). Furthermore, transactions with US subsidiaries should also be permitted transactions.

(5) Permitted trading outside of the US

<u>US domestic regulations should not be applied extra-territorially. The rule should not limit foreign banking entities' normal activities that are booked in non-U.S. accounts merely because these foreign entities conduct transactions with banking entities established in accordance with the US and State laws, or subsidiaries/branches of such US banking entities located outside the US</u>.

Cross-border transactions are widely conducted among major financial institutions, and it is not realistic to limit the scope of permitted trading outside the US. Therefore, the scope of permitted trading outside the US needs to be broadened. (Q136, 138)

Further, under the proposed rule, US regulators are expected to monitor all transactions (market making-related activities, etc.), including transactions conducted outside the US. However, it is practically impossible to cover activities that occur at foreign banking entities' non-US bases. <u>Activities that occur at bases outside the US are appropriately monitored by the home country regulators in relevant jurisdictions, so this</u>

proposal should be limited to cover only the activity of bases within the US. (Q80)

Above all, the following transactions with foreign banking entities should be permitted: (1) transactions outside the US—transactions between a foreign banking entity's base outside the US and a foreign banking entity's base outside the US (in other words, a transaction between foreign banking entities' bases outside of the US); (2) transactions concluded between a foreign banking entity's base outside the US and a US banking entity's base outside of the US. For the above case (2), in the case of a CDS transaction that designates a Japanese corporate as a reference obligor between a Japanese banking entity and a Japanese subsidiary or branch of the US banking entity, such a CDS transaction should be permitted for the Japanese banking entity. (Q138)

From the same perspective, one approach could be to classify transactions using the following three points—[the location where the transaction takes place (inside or outside the US)], [participants (US resident – hereafter, 'US') – non-US resident (hereafter, 'non-US'), US-US, non US- non US], and [participant's classification of accounts (trading account or banking account under the home country rules)]—and prohibit only those transactions that meet all three conditions: 'inside the US,' 'US-US,' and 'between trading accounts.'

Of the requirement *trading solely outside of the United States*, the criteria *(n)o party to the transaction is a resident of the United States* should be deleted. For example, when foreign banking entities conclude derivatives transactions with US banking entities in foreign countries, the proposed rule should not apply to the said foreign banking entity nor to the overseas local affiliate of the U.S. banking entity established in order to conduct trading outside the US. Assuming that even if a non-residency requirement is imposed, the second criteria *((ii) any partnership, corporation or other business entity organized or incorporated under the laws of the United States or any State)* and eighth criteria *((viii) any partnership or corporation organized or incorporated under the laws of any foreign jurisdiction formed by or for a resident of the United States)* in the definition of a US resident should be changed or eliminated. (Q136, 138, 139)

Furthermore, the criteria *(n)o personnel of the banking entity that is directly involved in the transaction is physically located in the United States* in the criteria *trading solely outside of the United States*, does not clarify the degree to which this should be addressed. Therefore, this requirement should be eliminated. (Q138)

Inter-company transactions conducted between local affiliates/branches in the US and Japanese parent or related companies should be permitted as transactions outside the US. The entire risk amount of the group may be reported to the US authorities, but risk adjustments within the group should not be restricted by regulations. Approving the risk adjustment within the group improves the stability of the relevant financial institution through effective risk capital allocations, and should also contribute to financial stability in the US. (Q138)

Moreover, executing facilities [like securities exchanges and swap execution facilities (SEF)] and intermediary agents should be explicitly excluded. (Q139, 140)

In Japanese business practice, cross-shareholding is sometimes done strategically. US companies' overseas listed subsidiary shares are also treated similarly. Subsidiaries of US companies should be excluded from the definition of *Resident of the United States*. (Q138)

It should be clearly noted that the definition of *outside of the United States* as included in this regulatory proposal is not used at any point in the entire Dodd-Frank Act.

4. Reporting and recordkeeping requirements applicable to trading activities

(1) General approach and Appendix A: Reporting and Recordkeeping Requirements for Covered Trading Activities

Threshold value (USD1 billion) for US branches of foreign banking entities that are not FDIC-insured should be calculated only for the US branches. Activities of US branches of foreign banking entities are unlikely to exceed non-US activities (including the headquarters), and it would not be meaningful for the calculation standards of thresholds that regulate US corporations' activities to include large non-US transaction amounts (Q150). Also, only the US branches of foreign banking entities that are not FDIC-insured should be required to monitor, report, and maintain records. (Q150, Q162, Q166)

Hedging activities in banking accounts (for financial accounting purposes) should not be subject to reporting and recordkeeping requirements. Excessive workloads imposed on foreign banking entities should be avoided through the exchange of information among relevant regulators.

(2) Attachment A: Reporting and Recordkeeping of Quantitative Measurements

Spread Profit and Loss should be excluded from quantitative measurement items. There are reliability issues regarding real time price information disseminated by information vendors like Reuters and Bloomberg, and this would cause various problems to arise. (Q168)

Customer-Facing Trade Ratio, Inventory Risk Turn Over, and *Pay-to-Receive Spread Ratio* should be excluded because they are difficult to measure. Derivatives hedges are dynamically executed hedges with frequent minor adjustments, and some items would be difficult to measure. Also, when market-making business is carried out with major interbank customers, like Japanese banking entities' U.S. swap subsidiaries do, it is difficult to distinguish whether the transactions can be characterized as market-making transactions or hedging transactions by the nature of the customer. In light of reporting timely, it seems that the burden of constructing a measurement structure and reporting thereafter would be extremely large. (Q168, Q169)

Furthermore, for some derivatives transactions like swaps, it is not practical to measure *Inventory Aging*, and this should be avoided. In market-making transactions like swaps transactions, positions are controlled by offsetting opposing transactions, and individual swaps transactions themselves are not sold. Individual transactions usually remain in the account until maturity, and it is not meaningful to measure the inventory holding period in such cases. Furthermore, we are concerned that there are reporting requirements under separate OTC derivatives rules under the Dodd-Frank Act, and overlaps in reporting should be avoided. (Q174)

Overall, it will be necessary for the banking entities to develop new systems to store bid-offer spreads for every transaction and hire analysis staff in order to measure such quantitative items. Even if considerable effort is made to change the systems, with transactions taking place during business hours, the quantitative measure at a specific point of time would not appear correctly in trading operations. The benefits would be outweighed by the costs. (Q174)

We think that *Comprehensive Profit and Loss*, and/or *Portfolio Profit and Loss* and *Fee Income and Expense* are sufficient quantitative measurement items in order to prove that major profits from market-making transactions are from customer transactions. （Q168, 173, 174）

5. <u>Other limitations on permitted proprietary trading activities (Definition of high-risk asset and high-risk trading strategy)</u>

The definition of *high-risk assets* is not clear, and the intent and specific examples of prohibited items in Footnote 215 (which lists prohibited items for *high-risk assets* and *high-risk trading strategies* as a compliance program) are unclear. In another part of this rule, quantitative reporting related to high-risk assets and high-risk trading strategies is defined, but the requirements for prohibited items are unclear. As with the treatment of ordinary instruments, we seek management within already-determined risk limits using a risk-based approach.

Or, a structure could be adopted to set out examples or instrument category figures, defer to individual banking entities to set the practical standards and operations and have the regulators review, or set a safe harbor rule. (Q213)

○ <u>Covered Funds Activities and Investments</u>

1. <u>Definition of *covered fund*</u>

(1) General comments

Of the funds subject to the rule that would be prohibited, foreign (Non-US) funds should be exempted from the scope of the rule. By prohibiting all foreign equivalents of "covered funds", all foreign private-offering funds with small numbers of professionals, including funds that make investments in funds other than private equity funds and hedge funds, would be included. As a result, unreasonable and significant adverse results could unintentionally impact foreign banking entities. Foreign funds at least should be exempted from prohibition.

(2) ABCP conduits

Investment companies that are exempted from registration with the SEC under the Investment Company Act section 3(c)(1), section 3(c)(7) are supposed to be included among the funds subject to the rule. A number of US and non-US ABCP conduits may fall under this category.. However, it is not necessary to make ABCP conduits—offered by banking entities for liquidity and credit support for securitizing customer obligations—subject to the rule, which is intended to address hedge funds and private equity funds.

(3) Loan securitizations

The acquisition or retention of any ownership interest in a covered fund that is an issuer of asset-backed securities is exempted from the rule. We request clarification that the acquisition or retention of any ownership interest in a private equity fund primarily comprised of loans should be permitted, other than those funds related to asset-backed securities. (Q221, 222)

2. <u>Permitted investment in a single covered fund</u>

Funds that are sold or offered to investors have to track records for an adequate length of time, and these must be disclosed to the investors. Investors in many countries, including Japan, often refer to track records of usually three to five years before making their investment decisions. However, if investment is recouped (in order to reduce ownership interest) only one year after a fund is established, there may be concerns that this could induce solicitations of investors in funds who cannot adequately assess performance. Further, mandatory and short-term investment liquidation could destabilize the fund, and could cause conflicts to arise with the lock-up periods required for investors. Therefore, the length of time for recouping investor funds should not be uniformly imposed, but from investor- protection view point, banking entities should be permitted some flexibility in setting the pace of recoupment (for example, noting this in the prospectus and/or obtaining approval from authorities, or obtaining approval from investors other than the sponsoring banking entity). (Q258)

The total amount invested in covered funds and the banking entity’s Tier 1 ratio should not be directly linked. The Tier 1 ratio of a banking entity is an indicator that could change depending on market conditions and regulatory changes. For example, capital losses occurring outside fund investment businesses could adversely impact maintenance and management of the fund investment. Thus, an event particular to a banking entity could impact the overall fund markets where general investors participate. Changes to a banking entity’s operations could expand the impact to market participants on a larger scale. This is therefore inappropriate from the perspective of maintaining market stability and investor protection. (Q268)

3. <u>Other permitted covered fund activities and investments</u>

(1) Permitted covered fund activities and investments outside of the United States (Q291- 295)

1) Requirements and definitions should be clarified

The rule permits certain foreign banking entities to acquire or retain an ownership interest in, or to act as sponsor to, a covered fund so long as such activity occurs solely outside of the United States, but the proposed definition of solely *outside of the US* is inadequate and must be clarified. In particular, the rule should at least clarify that the following cases constitute *permitted covered fund activities and investments outside of the US* (that is, acquiring and holding fund interests are allowed).

- ✧ Acquisition of funds registered with authorities in countries outside the US (mutual funds, ETFs);
- ✧ Fund managers of a banking entity that is not engaged in offering or selling to investors (banking entity is only making investments) are in the US;
- ✧ Transactions in which the fund advisors are in the US;
- ✧ Transactions in which funds outside the US access US markets (acquiring US stocks, US government bonds, and US-based funds); and
- ✧ Transactions on exchanges are located outside the US, even though reference assets are US instruments.

Further, the following should not be prohibited when determining requirements and definitions for *permitted covered fund activities and investments outside of the US*: 1) operations conducted through direct contact with customers (administrative operations and/or risk management operations) that do not directly relate to business activities; and 2) business activities conducted to meet customer needs (client services). In particular, above item (2) should be clearly articulated in the rule for the purpose of communications with cross-border investors In addition, the rule should explicitly state that if the three conditions below are met in *fund activities and investment outside of the US* by non-US banking entities, even if the said fund or fund manager is in the US, acquiring or holding fund interests would be exempt from the rule. (That is, the acquisition and holding of the said fund interests are permitted.)

- ✧ Non-US banking entities conducting investment activity in the said fund are not directly or indirectly controlled by a banking entity organized under the laws of the U.S. or one or more of the States;
- ✧ Investment activity in the said fund by a non-US banking entity (excluding administrative and back office activities) is not conducted by a subsidiary, affiliate, or employee incorporated or physically located in the US; and
- ✧ Equity interests in the said fund are not offered or sold to US residents.

Furthermore, it should be clearly stated that a regulatory compliance program requirement based on this rule is not necessary for operations *permitted as covered fund activities and investments outside of the US* (that are exempt from foreign transactions).

2) Requirement regarding *No ownership interest in such covered fund is offered for sale or sold to a resident of the United States*

The stipulation, *No ownership interest in such covered fund is offered for sale or sold to a resident of the United States* in §13 (c) (1) (iii) and §13 (c) (C)(3) (iii), should apply only to foreign banking entities that have sold or offered their ownership interest in the said fund to US citizen investors. (Ownership interests in unrelated funds that are not under control should not be covered by the rule.) This is for the three reasons below.

- ✧ Extraterritorial effect outside the US: For example, even acquiring ownership interest in Japanese acquisition fund that invests in Japanese companies and is comprised of Japanese general partners (GP) could be subject to the rule if there are US residents among other investors. However, this would constitute application of the rule outside the US to an excessive degree and would not be the intention of the Volcker Rule;
- ✧ Inconsistency with the intention of the Volcker Rule: Regulating investment by foreign banking entities in funds with US investors under limited partnership (LP) would be inconsistent with the intention of the Volcker Rule and also would not contribute to maintaining the competitiveness of US banking entities; and
- ✧ Difficulty in actively abiding with the rule: Generally, it is practically difficult for fund LP investors to comply with periodic or continuous monitoring to check that US residents are not among other investors. For example, after acquiring ownership interest in funds that cannot be controlled, we are concerned that 1) other investors' ownership interest itself could be bought by US residents; 2)

funds could start to offer or sell the interests to US residents; or 3) other investors themselves could be bought by US residents.

In the following two cases— 1) there is a two-layer fund structure in which a mother fund and multiple funds invest in the said mother fund (investors invest in feeder funds), and 2) the main fund and a parallel fund both managed by the same fund manager for the investors (investors exist in both the main and parallel funds)—it should be clearly stated that investors should assess the requirement "*No ownership interest in such covered fund is offered for sale or sold to a resident"* for each individual fund in which they directly invest, not for the overall structure. For example in the latter case, even in cases where the main fund or its fund manager is located in the US and the said main fund is subject to the Volcker Rule restrictions regarding acquiring and holding ownership interest, if the parallel fund is an offshore fund not in the US (e.g. the Cayman Islands) and the parallel fund does not sell ownership interest to US residents, then it should be expressly stated that Japanese investors who are solicited for investment in that parallel fund and any Japanese investments in that parallel fund would qualify under the Volcker Rule exemption regarding acquiring and holding ownership interest. (In other words, acquiring and holding ownership interest in the said fund would be permitted.)

3) If the requirement *No ownership interest in such covered fund is offered for sale or sold to a resident of the United States* extends to funds not controlled by a banking entity, the following measures should be implemented. (Q291-295)

The definitions in the proposed rule are too complicated, so the definition of *foreign funds* should be based on the location of the fund as noted in the prospectus.

Either of the following two methods should be allowed as sufficient explanation to show that funds are not offered or sold to US residents: 1) the sales prospectus states that the fund structure is not designed to allow US residents to purchase at the time of offering; or 2) at the time of purchase, confirmation is made that US residents are not among other investors. Also, when interests in funds not subject to the rule are offered or sold to US residents after acquisition, or when other investors’ interests are purchased by US residents, or when other investors themselves are bought by US residents, a special exception should be made so that this does not become an immediate violation of the rule.

(1) Sale and securitization of loans

The use of credit derivatives should be allowed in securitizing loans. In securitization transactions, diversifying banking assets is extremely important, and credit derivatives are a useful tool to achieve diversification when banking entities' loan assets intended for securitization are not enough for appropriate diversification. (Q300) Also, in §_14(d), because the originator of the securitization (including syndicates) may hold partial ownership of beneficiary rights, we ask that this be clarified so that the origination of the securitization is not obstructed.

4. Super 23A

Because the Volcker Rule would cover a wide range of funds and the requirements for exceptions (funds operating outside of the US) are strict, we are concerned that even non-US transactions that need not meet these requirements would be considered to be subject to the requirement.

Also, the so-called *Super 23 clause* prohibits covered transactions against funds in which banking entities act as sponsor or organizes and offer sales of ownership. . We are concerned about the adverse effects from the viewpoint of this clause being applied outside the US.

5. Appendix C: Minimum Standards for Programmatic Compliance

(1) Coverage of the compliance requirements

Imposing Appendix C on all banking entities would be inefficient and would result in a significant burden, especially when the businesses subject to the rule are relatively small. Therefore, the rationale for determining the threshold of the compliance program— trading assets and liabilities of USD1.0 billion or more, or 10% or more of total assets— should be clarified. We also ask that the following points be considered (Q320):

- ✧ In the scope of the compliance program outlined in Appendix C, the *§_.6 (d) Permitted trading outside of the United States* should be deleted. (Q320)
- ✧ We think that the balance of illiquid assets held temporarily during the conformance period should not be subject to assessment. When additional liabilities are needed, the treatment should be on a going concern basis. (Q320)
- ✧ We understand that an enterprise-wide compliance program would be required for the parent company and its subsidiaries in which the parent owns more than 25% of voting shares . For banking entities with a small ownership interest or low consolidated-standalone ratio, only the parent company should be required to comply with the program. (Q328, 329)

(2) Excessively-large burdens for foreign banking entities

Requiring foreign banking entities to comply with audit requirements by US regulators only for the purpose of Volcker Rule, , would constitute excessive extraterritorial effect. The overall compliance structure of a financial institution is verified through audits by home country authorities, and a solid system has been established. Compliance framework of home country authorities, including the Volcker Rule, have already been implemented at such financial institutions, and compliance measures only for the Volcker Rule should not be applied.

Compliance programs should be required to be carefully implemented in accordance with each individual banking entity's scale and attributes.

A tiered approach in accordance with scale has been outlined, but the rationale for setting threshold amounts is unclear.

For foreign banking entities that conduct all their fund-related transactions outside the US, it is sufficient to conclude that compliance is met if the transaction is conducted outside of the US, since the business is conducted outside the reach of US regulators, including the Federal Reserve Board.

If the system of internal controls is qualified and established under home regulators' supervision, it should be sufficient to have the testing for the effectiveness of the proposed compliance program be conducted by an internal audit department, and not require a qualified outside party. (Q333)

If an internal audit department is properly conducting independent testing, we think that the requirement for *a banking entity's CEO to annually certify that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program* is unnecessary. (Q337)

Reporting content, frequency, and additional standards under the compliance program should have some flexibility, for example, clarification of the expression of '*at least once.*'

○ Conformance Period (Q347) [2]

As with our comments in response to the FRB proposal regarding the conformance period for the Volcker Rule（*Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities* [Docket No. R–1397] published on November 26, 2010, the following points were not reflected. We ask that they be reconsidered.

(1) Extensions of transitional periods should be flexibly permitted

It may be difficult to sell investments in some covered funds that will be prohibited under the Volcker rule because of external factors such as market conditions.

Extension of holding periods of covered funds addresses a number of factors outlined in the FRB's §_.31 (d)(1). Regardless, transitional periods should be extended with flexibility when banking entities have difficulty settling the funds.

[2] The JBA submitted comments regarding conformance period on January 17, 2011, in response to the FRB proposal regarding the conformance period for the Volcker Rule, released January 26, 2010 (*Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities* [Docket No. R–1397]).

(2) Compliance program conformance periods

Establishing a compliance program, that would include risk management, not only on the basis of U.S. operations but also on a company-wide basis, would impose substantial costs for developing systems and hiring personnel. Further, substantial time would be needed for system implementation.

Reporting and recordkeeping requirements, as well as requirements under compliance programs (like covered transactions and covered funds), should be phased in, with cooperation among national regulators in different jurisdictions/countries.

There is a possibility that the final rules to be implemented may not be announced until close to July 12, 2012, when the rules start to apply. We ask for consideration that establishing internal structures will be difficult in realistic terms.

(3) Illiquid funds

In regard to the clause regarding illiquid funds, the difficulty regarding the mandatory disposal of previously-taken positions by private equity funds investment has been recognized. Therefore, we believe that a 10-year conformance period should apply at the timing of application by the banking entities, and approval by authorities is unnecessary.

The date of determination regarding liquidity or illiquidity for funds established May 1, 2010, or later should be clearly stated.