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By Electronic Mail

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW., Suite 3E–218,
Washington, DC 20219

Re: Proprietary Trading and Certain Interests in and Relationships With Covered Funds (Volcker Rule); Request for Public Input, Docket ID OCC–2017–0014

Ladies and Gentlemen:

The Institute of International Bankers ("IIB") appreciates the opportunity to comment on the request for public input[1] by the Office of the Comptroller of the Currency ("OCC") regarding Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[2] commonly known as the "Volcker Rule", and in particular the implementing regulations adopted thereunder (the "Final Rule").[3] We have focused our comments on the cross-border issues and potential extraterritorial effects of particular interest to internationally headquartered banks with U.S. banking operations ("international banks").

The IIB represents internationally headquartered financial institutions from over 35 countries around the world doing business in the United States. The IIB's members consist principally of international banks that operate branches and agencies, bank subsidiaries and broker-dealer subsidiaries in the United States. Our members' U.S. operations perform a vital role in providing credit to U.S. businesses and liquidity to U.S. financial markets. Collectively, our members' U.S. operations fund 27% of all commercial and industrial bank loans made in the United States, constitute three of the

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1 82 Fed. Reg. 36,692 (Aug. 7, 2017) (the "Request for Public Input").

2 Codified as Section 13 of the Bank Holding Company Act of 1956 (the "BHCA"), 12 U.S.C. § 1851.

3 As adopted by the OCC, the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC"), the Commodity Futures Exchange Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (together, the "Agencies"). See "Proprietary Trading and Certain Interests in and Relationships with Covered Funds", 79 Fed. Reg. 5536 (January 31, 2014) (the "Preamble"), codified at 12 C.F.R. pt. 44 (OCC), 12 C.F.R. pt. 248 (Federal Reserve), 12 C.F.R. pt. 351 (FDIC), 17 C.F.R. pt. 75 (CFTC), and 17 C.F.R. pt. 255 (SEC).

top ten U.S. agriculture lenders and funded 71% of U.S. infrastructure loan volume over the last five years. Our members contribute to the employment of hundreds of thousands of people in the United States in the financial sector and related service sectors. As providers of credit and other financial services in the United States, our members add diversity and competitiveness to the U.S. financial services markets, help U.S. businesses grow and promote U.S. and international financial stability. Our members also contribute more than $50 billion each year to the economies of major cities across the country in the form of employee compensation, tax payments to local, state and federal authorities and other operating and capital expenditures.

The Volcker Rule generally prohibits banking entities, including international banks, from (a) engaging in proprietary trading, as defined in the Final Rule, or (b) sponsoring, or acquiring or retaining an ownership interest in, a "private equity fund" or a "hedge fund" ("covered funds"), in each case subject to certain exemptions.[4] Congress deliberately and appropriately limited the extraterritorial reach of the Volcker Rule by excluding from the rule's prohibitions proprietary trading and covered fund activities conducted solely outside of the United States.[5]

Notwithstanding this Congressional intent to limit the application of the Volcker Rule outside the United States, certain provisions of the Final Rule require revision or clarification in order to implement this intent more faithfully and to avoid inappropriately disrupting the non-U.S. activities of international banks.

Based upon the most recent data from the Federal Reserve,[6] the global activities of over 140 foreign banks from 47 different countries are currently subject to the Volcker Rule, despite many of these institutions having very limited U.S. operations.[7] This has disrupted international banks' ability to trade with U.S. counterparties and trade through U.S. trading and clearing venues, it has hurt the U.S. companies that are customers and counterparties of international banks, it has discouraged new entrants into the U.S. banking system and it has generally negatively affected overall market liquidity. In 2015, international bank assets in the United States decreased by over $500 billion, largely due to Dodd-Frank implementation. In addition, over 20 international banks have exited the United States since the passage of Dodd-Frank, either by closing their U.S. operations entirely or by downgrading their U.S. operations to representative offices.

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4 BHCA § 13(a)(1).

5 See BHCA § 13(d)(1)(H) as implemented in Section ___.6(e) of the Final Rule (the "trading outside the U.S." ("TOTUS") exemption), and BHCA § 13(d)(1)(I) as implemented in Section ___.13(b) of the Final Rule (the "solely outside the U.S." ("SOTUS") exemption).

6 See Federal Reserve, Structure Data for U.S. Banking Offices of Foreign Entities (March 2017).

7 Of the international banks subject to the Volcker Rule, over 30 institutions have less than $50 billion in global consolidated assets, such that they are not subject to any of the enhanced prudential standards for systemically important financial institutions promulgated by the Federal Reserve under Section 165 of Dodd-Frank. Of the 110 institutions with more than $50 billion in global assets, 59% (65) have less than $10 billion in U.S. assets and 79% (87) have less than $50 billion in U.S. assets.

As indicated in our submission to the Department of the Treasury in relation to Executive Order 13772,[8] we believe that the Volcker Rule is fundamentally flawed, with numerous inherent problems that are not unique to its application to international banks, including its undue complexity, questionable policy basis and unintended consequences. The ongoing costs of compliance associated with the Final Rule have proven detrimental to the functioning of the U.S. and global markets, as liquidity, capital formation and clients suffer.[9] As the Request for Public Input notes, many senior regulators have acknowledged that the Volcker Rule's complexity has imposed excessive costs relative to its potential safety and soundness benefits and have questioned its practical utility.[10] To the extent it is not repealed by Congress, major revisions to the Final Rule are required to mitigate the adverse effects and unintended consequences it has created. Among other benefits, a comprehensive revision would provide an opportunity to further the "core principles" articulated by the current administration in Executive Order 13772,[11] including enhancing regulatory efficiency, making supervisory resources available for other, more important prudential goals and addressing a key source of arbitrary regulatory discretion, given the breadth of the Volcker Rule and the lack of clarity and coordination amongst the Agencies. Tailoring the rule to focus more effectively on the statute's underlying policy goals would also enhance U.S. markets' ability to build wealth for American citizens.

We applaud the OCC for taking the first step in such a review and appreciate the opportunity to provide input at this stage on how the Final Rule should be revised to help address certain flaws of particular concern to international banks. As requested in the Request for Public Input, we have limited our recommendations to changes that may be implemented through rulemaking and where possible we have provided relevant data that we have gathered from our member institutions.

The principal concern for international banks is the Final Rule's unwarranted extraterritorial reach and the resulting undue burden on their non-U.S. operations. For those international banks to which the Volcker Rule applies, we strongly urge that it be applied solely to their U.S. operations, as originally intended by Congress. While the Volcker Rule statute included carve-outs for trading and fund activities conducted solely outside the United States, in the Final Rule the Agencies limited these carve-outs in ways that impeded the congressional intent to exclude non-U.S. activities in a manner consistent with longstanding U.S. (and international) banking regulation and supervision. Through subsequent guidance, the Agencies have addressed some key issues of concern with respect to

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8 Institute of International Bankers, U.S. Supervision and Regulation of International Banks: Recommendations for the Report of the Treasury Secretary (2017) ("IIB's Treasury Recommendations").

9 See Jack Bao, Maureen O'Hara & Alex Zhou, The Volcker Rule and Market-Making in Times of Stress, (Federal Reserve Board Finance and Economics Discussion Series No. 2016-102, Sept. 2016) (indicating a decrease in liquidity in certain markets).

10 See, e.g., Daniel K. Tarullo, Governor, Federal Reserve, "Departing Thoughts" (Apr. 5, 2017) ("Tarullo Departing Thoughts") (In his view, "the inquiry into the intent of the bankers making trades to determine . . . whether the trades were legitimate market making" has become "time-consuming", "unsuccessful" and, in his words, the Agencies need to "try something else"); William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York (April 7, 2017) ("Dudley Remarks").

11 See "Presidential Executive Order on Core Principles for Regulating the United States Financial System", Executive Order 13772 (Feb. 3, 2017).

non-U.S. fund activities,[12] but the overly narrow scope of the TOTUS exemption has created extremely problematic burdens on international banks' non-U.S. activities. The Volcker Rule should not prohibit activities by international banks where the bank's risk associated with the activity resides outside the United States. Additionally, in the area of non-U.S. funds activities, a permanent solution is still required for the apparently unintended consequence of the Volcker Rule's proprietary trading and funds prohibitions being applied to controlled non-U.S. funds.[13] For the same reasons discussed above, the focus on fund activities should be on where the risk resides as opposed to being driven by legal structure or local governance arrangements. Finally, the Agencies should clarify that the Volcker Rule's compliance program obligations and metrics reporting requirements (to the extent they are retained) apply only to an international bank's U.S. operations.

Many of our member institutions engage in very limited U.S.-located activities that fall within the scope of the Volcker Rule. We strongly endorse the recommendations included in the recently issued report by the Department of the Treasury (the "Treasury Report")[14] to apply the Volcker Rule based upon the banking organization's size or scope of proprietary trading activities, such that smaller banking organizations would be entirely exempt from the Volcker Rule[15] and the enhanced compliance program would only apply to those banking organizations with significant proprietary trading operations.[16] Similarly, we urge that such exemptions be applied to international banks based upon their U.S. presence (measured, for example, by their U.S. assets or U.S. trading assets and liabilities) such that international banks with very limited U.S. operations would similarly be excluded from the Volcker Rule. Such an approach is consistent with the Treasury Report's rationale for excluding smaller banking organizations as, despite their very limited U.S. operations, the Volcker Rule currently requires international banks to implement a global compliance program. As the Treasury Report indicates with respect to smaller banks, "[the] relatively small risk that these institutions pose to the financial system does not justify the compliance burden of the [Final Rule], and the risk posed by the limited amount of trading that banks of this size could engage in can easily be addressed through existing prudential

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12 See, e.g., Frequently Asked Question #13, providing guidance on the scope of the SOTUS exemption "consistent with limiting the extraterritorial application of section 13 to foreign banking entities while seeking to ensure that the risks of covered fund investments by foreign banking entities occur and remain solely outside of the United States." (emphasis added).

13 In July of this year, the Agencies recognized this problem and provided temporary relief, until July 21, 2018, but a permanent resolution is urgently needed as this issue has ongoing impact on international banks' non-U.S. funds activities. See Federal Reserve, OCC and FDIC, Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (Jul. 21, 2017) (the "Foreign Fund Guidance").

14 See Department of the Treasury Report, A Financial System that Creates Economic Opportunities: Banks and Credit Unions (June 2017).

15 Id. at 72-73 ("[F]irms that are small or do not engage in significant proprietary trading should not be subject to the Volcker Rule.")

16 Id. at 77 ("[T]he existing 'enhanced' compliance program under the [Final Rule] should be focused in application . . . All banks should be given greater ability to tailor their compliance programs to the particular activities engaged in by the bank and the particular risk profile of that activity.").

regulation and supervision."[17] Such rationale should apply equally to foreign banks with limited U.S. operations, without creating risks to the U.S. financial system or competitive inequality concerns.

The second area of significant concern relates to the definition of proprietary trading. The chief source of complexity and overbreadth arising from the Volcker Rule's proprietary trading prohibition is the presumption that all transactions in financial instruments are proprietary trading unless an institution can prove that the transaction meets the elements and conditions of regulator-determined exceptions and exclusions. Reversing this presumption, to preserve customer-driven market activity while targeting purely speculative proprietary trading, would go a long way toward focusing the Volcker Rule on the activities it was intended to prohibit. It could also remove the unreasonably burdensome layers of policies, procedures and quantitative metrics required to "prove the negative proposition" that an institution does not engage in prohibited proprietary trading.

The third overarching issue is the overly broad and unduly complex definition of "private equity and hedge funds." This definition should be revised to reflect the originally intended purpose of the funds prohibitions, which was to prevent circumvention of the proprietary trading prohibitions, promote the safety and soundness of banking entities by limiting their exposure to funds that are engaged in short-term trading and prevent taxpayer bailouts by minimizing banking entities' exposure to undue risk, without the adverse effects on liquidity and the availability of client-oriented financial services.[18] The overbroad covered funds definition causes the Volcker Rule to restrict a wide variety of fund, securitization and unrelated intermediation and asset management activities in ways that Congress did not intend. This problem is especially acute in the context of non-U.S. activities, where structures and concepts based on U.S. regulatory definitions rapidly break down in application. An activities-based definition of private equity and hedge funds focused on proprietary short-term trading would help address this issue, especially outside the United States, by looking at the activities and associated risks of the funds, as opposed to their legal entity structure.

Finally, we repeat here the call from IIB's Treasury Recommendations for streamlining the interpretive authority under, and examination and enforcement of, the Volcker Rule. The diffusion of responsibility and authority across the five Agencies has contributed significantly to uncertainty and

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17 Id. at 72.

18 82 Fed. Reg. at 36,693 ("The Volcker Rule was intended to promote the safety and soundness of banking entities and prevent taxpayer bailouts by minimizing bank exposure to certain proprietary trading and fund activities that could involve undue risk. At the same time, the Volcker Rule was designed to permit banking entities to continue providing client-oriented financial services that are critical to capital generation and that facilitate liquid markets."). See also 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement by Sen. Dodd) ("The purpose of the Volcker Rule is to eliminate excessive risk taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest. It prohibits proprietary trading and limits bank investment in hedge fund and private equity for that reason."); Financial Stability Oversight Council ("FSOC"), Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships With Hedge Funds & Private Equity Funds at 46 (Jan. 2011) ("FSOC Volcker Study") ("The purpose of [the funds prohibition] is to: 1. Ensure that banking entities do not invest in or sponsor such funds as a way to circumvent the Volcker Rule's restrictions on proprietary trading; 2. Confine the private fund activities of banking entities to customer-related services; and 3. Eliminate incentives and opportunities for banking entities to 'bail out' funds that they sponsor, advise, or where they have a significant investment.").

ambiguities in the Final Rule's implementation. Former Federal Reserve Board Governor Tarullo specifically identified the search for consistency across the Agencies as one of the root causes of the implementing rules' complexity.[19] Involving five separate Agencies in the Volcker Rule's implementation has also led to a lack of accountability and transparency, as a single Agency can stand in the way of consensus and block practical solutions to some of the Volcker Rule's many ambiguities, inefficiencies and unintended consequences. Consequently, the five Agency working group has not been an efficient or effective forum to interpret the Final Rule or obtain clarification and guidance. This has resulted in delays in the issuance of guidance and the attendant waste of substantial resources of banking organizations trying to implement compliance programs in the midst of this ambiguity.[20] At times, banking organizations have also received contradictory guidance during examinations from different members of the working group.[21] The most effective solution to the problem of coordinating across five agencies would be for Congress to assign rulemaking and interpretive authority to a single agency. Absent such a statutory change, the Agencies should agree to give one prudential regulatory agency the lead role in developing and providing interpretive guidance and more effectively coordinate examination and enforcement activity with respect to entities under their supervision.

We urge the OCC and other Agencies to issue a new advanced notice of proposed rulemaking or a new proposed rule with the goal of reducing negative effects on customers, the markets and banking entities by returning to the intended scope of the statute. Given the broad consensus regarding the need for substantial revisions to the Final Rule, including the significant revisions recommended in the Treasury Report and the many areas of continued ambiguity still awaiting clarification, we also urge the Agencies to publicly communicate their intention not to take actions against banking institutions in connection with Volcker Rule compliance until clarifications and revisions to the Final Rule are completed.[22] Our key recommendations are summarized below.

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19 See Tarullo Departing Thoughts ("The first statutory problem is that five different agencies are involved. . . . [T]he disadvantages [of this approach] seem to dominate.")

20 As just one example, in the second annual (March 2017) round of CEO attestations regarding banking organizations' Volcker Rule compliance programs, many banks filed their CEO attestations according to the same processes, procedures and language that the Agencies had accepted in the prior year and were only told after the filing that the language used in the prior year would not be accepted. As a result, many banking organizations found it necessary to repeat their reporting-up processes, processes that typically start at least three months and on average five months before the March deadline, adding unnecessary costs and diverting resources.

21 Based on feedback from our members, the level of attention and examinations from the Agencies has varied dramatically. While most of our members have not undergone formal Volcker Rule readiness or compliance examinations to date, certain institutions have received multiple examinations and information requests from multiple Agencies. This has exacerbated both the perception of, and actual, differential application of the Volcker Rule across the industry.

22 This approach would be consistent with action previously taken by the banking Agencies with respect to foreign private funds. See Foreign Fund Guidance.

<u>Key Recommended Regulatory Changes</u>

1. The Volcker Rule's extraterritorial reach should be appropriately limited, as Congress intended, and the Volcker Rule's restrictions and compliance obligations should stop at the "water's edge".

2. Consistent with the Treasury Report's recommendations, smaller banking organizations should be excluded from the scope of the Volcker Rule. The threshold for such an exemption should be applied to international banks based on their U.S. assets and operations, thereby exempting international banks with limited assets or proprietary trading operations in the United States.

3. Certain entities should be excluded from the scope of the Volcker Rule.

    a. Non-consolidated, minority-owned and operationally non-controlled non-U.S. investee companies of an international bank subject to the Volcker Rule should be excluded from the definition of "banking entity" unless they themselves have Volcker Rule-triggering banking operations within the United States.

    b. Non-U.S. commercial investee companies comparable to U.S. merchant banking portfolio companies should be excluded from the definition of "banking entity".

4. The proprietary trading provisions should be modified to:

    a. Restore the TOTUS exemption to its originally intended scope by exempting trading activity by any non-U.S. banking entity that (i) is not directly or indirectly controlled by a banking entity organized in the United States and (ii) books the trading position and associated risk as principal outside the United States. The restrictions on U.S. personnel of the international bank or its counterparty arranging, negotiating and executing trades and on trades conducted with or through U.S. entities (including the foreign operations of U.S. entities) should be eliminated.

    b. Reverse the current presumption that each purchase or sale is deemed to be a proprietary trade unless demonstrated to be outside of the trading account or otherwise excluded from the definition of proprietary trading in favor of a principles-based approach that narrowly defines and prohibits impermissible proprietary trading activity.

    c. Expand the exemption for trading in foreign sovereign debt to permit trading to the same extent as U.S. government debt and to permit trading in derivatives on foreign government obligations.

    d. Categorically exempt activities and business units subject to banking book regulatory capital and accounting treatment from the definition of proprietary trading and, in particular, provide a categorical, principles-based exemption for treasury, funding, asset-liability management ("<u>ALM</u>") and similar functions.

e. Exclude cross-currency swaps, FX funding swaps and other common cross-currency financing transactions ("FX Funding Transactions") that are the functional equivalent of currency repurchase agreements or lending transactions from the definition of "proprietary trading".

f. Clarify that riskless principal derivative transactions are exempt from the Volcker Rule.

g. Exclude identified banking products and participations in identified banking products from the definition of "financial instrument".

5. In relation to the covered funds provisions, the Final Rule should be modified to:

a. Replace the current definition of covered fund with an activities-based definition focused on private funds that engage primarily in short-term proprietary trading in order to implement the original purpose of the covered fund prohibition.

b. Exclude from the definition of banking entity:

i. Controlled, bona fide investment funds (pooled investment vehicles and managed accounts) that are excluded from the definition of covered fund because they are organized and offered outside of the United States; and

ii. Funds that are organized and offered pursuant to another exclusion from the definition of covered fund (e.g., foreign public funds, loan securitizations, registered investment companies, employees' securities companies, etc.).

c. Revise the foreign public fund exclusion to focus on the qualification of the fund in its jurisdiction of organization or principal foreign markets as eligible for retail sales, similar to the Volcker Rule's treatment of registered investment companies in the United States, rather than imposing specific conduct requirements based on the actual manner of the fund's primary offering.

d. Permit foreign banks to hold investments in foreign securitizations that are covered funds to the extent mandated by non-U.S. risk retention rules.

e. Confirm that limits on aggregate covered fund investments should be calculated based on global Tier 1 capital, and should not be applied at the level of an international bank's U.S. intermediate holding company ("IHC") .

f. Narrow the restriction on covered funds sharing a name with a banking entity or its affiliates.

g. Align the "Super 23A" prohibition with Section 23A of the Federal Reserve Act and the Federal Reserve's Regulation W[23] by:

i. Incorporating the exemptions from Section 23A and Regulation W into Super 23A; and

ii. Clarifying that Super 23A does not reach transactions by an international bank, or its affiliate, acting outside the United States.

6. The Agencies should designate one prudential regulatory agency to have the lead role in developing and providing interpretive guidance and coordinate with the other Agencies in examination and enforcement.

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[23] 12 C.F.R. Part 223.

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I. Limiting the Unwarranted Application of the Volcker Rule Outside the United States

The Volcker Rule was enacted as part of the BHCA, a statute with broad global application. The Volcker Rule applies globally to the affiliates and subsidiaries of international banks with U.S. operations (with some limited exceptions), whether or not those affiliates are substantially involved in activities in the United States or pose risks to the U.S. financial system. Over 140 international banks have had to apply the Volcker Rule to thousands of entities globally.

In the past, the Federal Reserve's implementation of the BHCA, including Section 4(c)(9), referenced by the Volcker Rule, has limited the impact of U.S. banking laws outside the United States. Thus, while the BHCA applies on a global basis, very broad exemptions for non-U.S. activity appropriately limit the application of U.S. law to international banks.[24]

Similarly, while the Volcker Rule statute applies on a global basis, the statute's TOTUS and SOTUS exemptions specifically aimed to prevent the Volcker Rule from restricting the activities of international banks conducted outside the United States.[25] These territorial limits on the Volcker Rule's application are premised in part on the understanding that the non-U.S. activities of international banks do not benefit from FDIC insurance, do not pose a risk to U.S. financial stability and do not create a risk of U.S.-taxpayer funded bailouts.[26] However, the Final Rule did not faithfully implement these statutory exemptions for overseas activities. The Final Rule presumes non-U.S. activity is covered unless the multiple conditions of specific, narrow exemptions for international activity can be satisfied. Several of these conditions are not workable in practice and are not required by the statute. Therefore, as implemented, the Final Rule applies extraterritorially to a much broader scope of activities than Congress intended in the statute[27] or than is necessary to accomplish its policy goals.

Under the Final Rule, it is the interplay among the rule's global application to all affiliates, its broad definition of proprietary trading, the narrowness of the TOTUS exemption, the unintended application of the Volcker Rule prohibitions to non-U.S. funds and the limited scope of the

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24 For example, BHCA regulations have long permitted qualifying international banks to "engage in activities of any kind outside the United States", "engage directly in activities in the United States that are incidental to its activities outside the United States" and "own or control voting shares of any company that is not engaged, directly or indirectly, in any activities in the United States, other than those that are incidental to the international or foreign business of such company" (the "BHCA Offshore Authorities"). See 12 C.F.R. Part 211, Subpart B, and in particular 12 C.F.R. §§ 211.23(f)(1)-(3).

25 See TOTUS exemption (permitting "proprietary trading conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c) [of the BHCA], provided that the trading occurs solely outside of the United States and that the banking entity is not directly or indirectly controlled by" a U.S. banking entity); SOTUS exemption (similar permission for investments in, or sponsorship of, funds that are not offered or sold to U.S. residents).

26 See FSOC Volcker Study ("[B]ecause of U.S. extra-territorial regulatory constraints, the statute does not restrict proprietary trading conducted by non-U.S. entities outside the United States. These entities are not eligible for discount window loans or federal depository [sic] insurance.").

27 See, e.g., 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("[The Volcker Rule] recognize[s] rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law.").

SOTUS exemption to apply only to "covered funds" that creates the exceptional and unwarranted lack of territorial limits on the Volcker Rule's application. For every overseas entity for which "control" did not previously raise U.S. regulatory concerns (because, e.g., its activities were permissible under the BHCA Offshore Authorities),[28] suddenly an entire compliance regime may need to be imposed to determine if the non-U.S. company trades with even a single U.S. entity (including overseas subsidiaries or affiliates of a U.S. company) or invests in, trades with or advises a potential covered fund. Many of the problems associated with the scope of the Volcker Rule's application outside the United States would be mitigated if the TOTUS and SOTUS exemptions were more effectively implemented in the Final Rule to better reflect Congressional intent and longstanding principles of international bank regulation, consistent with the BHCA Offshore Authorities.

The structure of the Final Rule's proprietary trading prohibitions and TOTUS exemption is especially problematic because it discourages international banks from trading with U.S.-based customers and dealers in favor of their non-U.S. competitors, thereby creating risks and costs to U.S. customers, harming U.S. companies' access to markets and disadvantaging U.S. dealers' access to liquidity. It also creates potential conflicts or duplication with international banks' home-country laws and regulations and supervisory standards,[29] which creates unnecessary friction in negotiations between the United States and other countries regarding cross-border financial services and encourages other jurisdictions to adopt retaliatory measures applicable to U.S. banks that operate overseas. Ironically, many of the most complicated and ambiguous aspects of the Final Rule have arisen in the context of interpreting the Volcker Rule's application to foreign activities and entities, even though the principal purpose of the Volcker Rule was to reduce the risk of banking entities' U.S. activities.

Applying the Volcker Rule globally comes with substantial compliance costs that are disproportionate to international banks' activities in the United States. In addition to necessary modifications to the implementation of the TOTUS and SOTUS exemptions, international banks should not be required to implement a global compliance program designed to ensure that their foreign operations meet these narrow and highly technical exemptions. The implementation of the Volcker compliance program has resulted in foreign banks incurring hundreds of millions of dollars in external and internal costs in order to comply with the overbroad application of a U.S.-designed rule to their foreign operations, requiring thousands of hours of training for activities, the vast majority of which are solely offshore. Based upon data from 16 IIB members of various sizes, the U.S. operations of international banks represent an average of 14% of their global operations and U.S. trading assets (as calculated for metrics purposes) represent on average less than 1% of global assets. Despite the fact that international banks' activities are overwhelmingly conducted, booked and held outside the United States (such that the risk also resides outside the United States), thousands of non-U.S. banking entities must comply with the Volcker Rule's restrictions, including the associated compliance burdens. Layering the Final Rule's granular and overly prescriptive compliance program requirements on whole entities or

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28 The Final Rule's extraterritorial reach has caused international banks to analyze retroactively their relationships with many non-U.S. entities because of the significant possibility of "control" and applicability of the Final Rule. Many of such relationships were created under local commercial and legal constructs, based on the limited touch permitted under the BHCA Offshore Authorities. This retroactive analysis has created unwarranted tensions with international banks' investor partners and investee companies.

29 For example, both Germany and France implemented regulations putting in place restrictions on proprietary trading in 2013 and 2014, respectively.

business lines overseas does not provide benefits to overall industry compliance and merely creates running program maintenance costs that curtail the availability of products and services.

Among other things, these costs and burdens have resulted in the loss of participants in the U.S. marketplace. We are aware of at least seven international banks among our membership that have terminated or transferred existing transactions with U.S. counterparties in order to comply with the TOTUS exemption and to avoid incurring significant additional compliance costs associated with reliance on an alternative exemption (such as market-making or risk-mitigating hedging). The broad extraterritorial application of the Volcker Rule also discourages entry into the U.S. banking system from overseas due to concerns about the limits and compliance burden on non-U.S. activities, leading to a reduction in foreign investment and related jobs in the U.S. financial and commercial sectors. For example, while over 20 international banks have exited the United States since the passage of Dodd-Frank, only three international banks have entered the U.S. market.[30]

In order to avoid these adverse effects, which serve no legitimate U.S. prudential purpose, the Volcker Rule's extraterritorial reach should be appropriately limited, and the Volcker Rule's restrictions and compliance obligations should stop at the "water's edge", as Congress intended. In particular, at a minimum, if (1) our recommendation to modify the scope of the TOTUS exemption to adhere to Congressional intent and to make it more workable and available (see Section III.A below) were adopted, (2) the full scope of the Final Rule's compliance program, attestation, reporting, metrics and prudential "backstop" provisions were to stop at the water's edge and apply only to the U.S. operations of international banks and (3) the tailored application of the Final Rule to the fund-related activities of international banks, as recommended in Section IV below, were adopted, these would address a large portion of the unwarranted extraterritorial costs and burdens of the current rule.

The original policy justification of the Volcker Rule was to protect the U.S. financial system and U.S. financial institutions from the risks of speculative proprietary trading. An appropriately tailored approach to implementing the Volcker Rule would limit its impact to the U.S. operations of international banks, rather than regulating the conduct of international banks outside of the United States. Throughout this letter, we provide specific recommendations to appropriately limit the extraterritorial application of the Volcker Rule in a manner more consistent with Congressional intent.

II. Relief for Banks with Limited U.S. Activities and Certain De Minimis or Non-U.S. Controlled Companies

A. Exclude smaller banks, and apply that exclusion equally to international banks with limited assets or proprietary trading operations in the United States

Our concern regarding the disproportionate extraterritorial reach of the Final Rule and the resulting burden on non-U.S. operations is particularly acute for international banks with very limited U.S. activities. **We strongly endorse the Treasury Report's recommendations to exclude smaller banking organizations from the scope of the Volcker Rule. We urge that the threshold for such an exemption be applied to international banks based on their U.S. assets and operations, thereby**

[30] Note that this does not include institutions that have entered the U.S. markets by opening representative offices, as such entrants would not be subject to the Volcker Rule.

exempting international banks with limited assets or proprietary trading operations in the United States.

Limiting the scope of the Volcker Rule to those international banks that have significant U.S. assets or a significant proportion of U.S. covered activities would, consistent with the Treasury Report's rationale for excluding smaller banking organizations, reduce the excessive burden on international banks with minimal assets and operations in the United States, thereby freeing up capital to increase investment in the United States and across the globe. Excluding these entities would, by definition, not materially increase potential risks to the United States given their very limited U.S. footprints.

B. Exclude non-consolidated, minority-owned and operationally non-controlled non-U.S. investee companies of international banks

The Volcker Rule exports the BHCA's broad definition of control and affiliation in a manner not previously applicable to international banks given the general territorial limits of other BHCA provisions.[31] Control or affiliation can be triggered by an investment representing only 25% of a class of voting securities or an investment that has "controlling influence" from, e.g., more than minimal minority protective veto rights. As a consequence, non-U.S. minority-owned entities may be subject to Volcker Rule compliance burdens even when an international bank has no actual operational control over the entity and when the exercise of operational control over the entity was not previously required under local or home country law (or the extraterritorial application of U.S. regulations). The scope of application of the BHCA (and thus the Volcker Rule) is often significantly broader than an international bank's home country rules defining which entities are within the international bank's regulatory and supervision perimeter.

For example, if a European bank with U.S. banking operations has a strategic minority investment in an Asian broker-dealer that is deemed "controlling" for BHCA purposes, that Asian broker-dealer would become subject to the Volcker Rule and could not transact "with or through" any U.S. customer, counterparty or agent (applying the sweeping U.S. entity definition) without complying with the various requirements as to the broker-dealer's personnel, counterparty personnel, trading venue and clearing status. Similar situations arise frequently and often result in disproportionate compliance burdens for minority-owned "affiliates" that have little or no connection to the United States.[32] Such affiliates may be deterred from expanding into the United States or offering their products or services to U.S. persons (and boosting U.S. employment and liquidity to the U.S. financial markets) because it is easier for such a minority-owned entity to simply avoid U.S. connections rather than put in place a nuanced compliance plan (and, conversely, it is difficult for an international bank to monitor a minority-owned non-U.S. entity's compliance with the Volcker Rule because of lack of operational control over the entity).

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[31] See 12 C.F.R. Part 211, Subpart B, and in particular the BHCA Offshore Authorities.

[32] Indeed, application of traditional BHCA control principles even cause "second-tier" minority-owned "affiliates" to be deemed banking entities; under the BHCA, if a BHC has a 30% voting investment in a company, and that company has a 30% voting investment in another company, the second-tier company would be deemed an affiliate of the BHC.

Additionally, in certain jurisdictions, local law or market expectations require serving as a minority partner without operational controls in order to attain a license to offer certain financial products or services in the country. As a result, while such an investment may be a "controlling" investment from the BHCA perspective, the international bank will frequently lack contractual rights or legal recourse to require the entity to comply with the Volcker Rule, absent the international bank divesting its minority interest.

In effect, the BHCA control definition and broad scope of the Volcker Rule are retroactively applying significant activity limitations to non-U.S. entities the investments in which were not originally structured either to avoid U.S. BHCA "control" or to limit the target entity's activities. As minority investors, international banks may not have sufficient leverage or contractual rights (absent divesting or litigation) to compel these entities to institute a Volcker compliance program, as many of these legacy investments may have only included requirements that the entity comply with the activity restrictions required to rely on the Federal Reserve's Regulation K (which are different from the activity restrictions under the Volcker Rule, and under TOTUS, in particular).

To minimize these unintended and unnecessary extraterritorial burdens, the non-consolidated, minority-owned and operationally non-controlled non-U.S. investee companies of an international bank subject to the Volcker Rule should be excluded from the definition of "banking entity" and fully exempt from the Volcker Rule's prohibitions unless they themselves have Volcker Rule-triggering banking operations within the United States.

An example of this approach can be seen in the final swap margin rules promulgated by the OCC, FDIC, Federal Reserve, Farm Credit Administration and Federal Housing Finance Agency, which adopted accounting consolidation as the standard for determining subsidiary and affiliate status, after initially proposing a 25% "control" standard similar to that used in the BHCA.[33] While the Volcker Rule statute applies the BHCA control test to international banks when determining which affiliated entities are "banking entities" subject to the regulations, the Agencies created several carve-outs from the definition of "banking entity" in the Final Rule and have subsequently exempted additional types of controlled entities from the Volcker Rule's prohibitions through guidance.[34] Therefore, this recommendation could be adopted without statutory change, consistent with the manner in which the Federal Reserve has limited the extraterritorial application of other BHCA provisions and consistent with Congressional intent.

Excluding such non-U.S. entities would be consistent with the intended scope of the Volcker Rule, focused on entities that have, or are operationally integrated with entities that have, banking operations in the United States. The activities of non-U.S. entities that would be excluded under this recommendation would present no risk of U.S. taxpayer funded bailouts and are of quite limited prudential concern for U.S. regulators.

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[33] See 80 Fed. Reg. 74,840, 74,860 (Nov. 30, 2015).

[34] See, e.g., Final Rule ___.2(c)(2); Volcker Rule Frequently Asked Question #14, Foreign Public Funds Sponsored by Banking Entities (June 6, 2015); Volcker Rule Frequently Asked Question #16, Seeding Period Treatment for Registered Investment Companies and Foreign Public Funds (July 16, 2015).

C. Exclude non-U.S. commercial investee companies comparable to U.S. merchant banking portfolio companies

Section ___.2(c)(2)(ii) of the Final Rule appropriately excludes from the definition of banking entity merchant banking investments that are owned or controlled pursuant to Section 4(k)(4)(H) of the BHCA and Subpart J of the Federal Reserve's Regulation Y thereunder (the "Merchant Banking Rule" and such companies, "Merchant Banking Portfolio Companies").[35] We supported this exclusion, because Merchant Banking Portfolio Companies are commercial companies that generally do not engage in financial activities of the type regulated by the Volcker Rule, are not integrated into the operations of the financial holding company that controls them and a financial holding company's relationships with its Merchant Banking Portfolio Companies are subject to significant restrictions under the Merchant Banking Rule.[36]

Similar considerations support the exclusion of commercial companies that an international bank controls, including those it holds pursuant to BHCA Section 2(h)(2) ("2(h)(2) Companies") and the Federal Reserve's implementing regulations thereunder.[37] While limited, this authority recognizes that international banks may also make "merchant banking" investments under applicable home country laws and regulations, and it provides an important limitation on the extraterritorial reach of the BHCA.

Controlling investments by international banks in 2(h)(2) Companies should not require those target commercial companies to become "banking entities" subject to the Volcker Rule. Although 2(h)(2) Companies may be "subsidiaries" of an international bank as defined in the BHCA (and therefore would be "banking entities" under the Final Rule), they are clearly outside the intended scope of the Volcker Rule from a policy perspective. As with Merchant Banking Portfolio Companies, to the extent 2(h)(2) Companies have U.S. operations, those operations are limited to commercial activities and are not integrated into the U.S. financial operations of the international bank that controls them. Application of the Volcker Rule to these non-U.S. commercial companies would serve no material supervisory purpose, would represent an unnecessary and unintended departure from longstanding U.S. supervisory and regulatory approaches to these investments and would be inconsistent with the principle of national treatment, under which 2(h)(2) Companies should be treated no worse under the Volcker Rule than Merchant Banking Portfolio Companies.[38] **For these reasons, we recommend that 2(h)(2) Companies be excluded from the definition of banking entity in the Final Rule.**

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35 12 U.S.C. § 1843(k)(4)(H) and (I); 12 C.F.R. pt. 225, subpart J.

36 See 12 C.F.R. § 225.171 et seq.

37 Under BHCA Sections 2(h)(2) and 4(c)(9), as implemented by Section 211.23(f) of the Federal Reserve's Regulation K, qualifying foreign banking organizations ("QFBOs") are authorized to hold controlling investments in non-U.S. commercial companies, including, subject to certain restrictions, commercial companies that engage in activities in the United States through U.S. offices and subsidiaries. These restrictions include requirements that the investing international bank qualify as a QFBO, limits on the nature and relative size of the target company's U.S. operations, prohibitions on engaging in financial activities in the United States, lending and cross-marketing restrictions, etc. See 12 U.S.C. §§1841(h)(2) and 1843(c)(9); 12 C.F.R. § 211.23(f).

38 In recognition of the clear operational separation between 2(h)(2) Companies and the U.S. operations of the international banks that control them, the Federal Reserve determined to exclude 2(h)(2) Companies from

III. Proprietary Trading Prohibition

The Volcker Rule's trading restrictions are too complex and hinder banking organizations' ability to provide lending, intermediation and liquidity services. These restrictions burden all banks—big and small, U.S. and international—with onerous compliance obligations. These burdens are especially onerous and misguided when applied to international banks' non-U.S. operations, which were never intended to be affected by the Volcker Rule's prohibitions. There are many aspects of the Volcker Rule's proprietary trading restrictions, exemptions and compliance obligations that should be fundamentally reevaluated and revised. Our letter makes seven recommendations addressing areas of particular concern to our members as international banks.

A. Clarify the TOTUS exemption to exempt all trading activities where the risk is booked outside the United States

The Volcker Rule was never intended to apply to international banks' non-U.S. operations.[39] The non-U.S. trading and booking activities of international banks do not benefit from FDIC insurance, pose no risk to U.S. financial stability and create no risk of U.S.-taxpayer-funded bailouts. Accordingly, the statutory exemption for trading by an international bank outside of the United States was designed to permit international banks to continue to engage in trading activities outside of the United States where the balance sheet risk is borne by foreign entities, not U.S. financial institutions. However, the Final Rule's conditions for relying on the TOTUS exemption unnecessarily and inappropriately go beyond a focus on the location of the risk of the activity as principal to prohibit connections to the United States that have no bearing on risk to the U.S. financial system or U.S. financial institutions. These additional restrictions have a direct, negative impact on U.S. dealers, companies and persons' access to market share, capital, liquidity and wealth generation opportunities.

There are two specific restrictions in the Final Rule's TOTUS exemption that go beyond what the statute requires. First, the TOTUS exemption is unavailable for any trade where any of the banking entity's personnel that "arrange, negotiate or execute" the trade are located in the United States, or where the trade is conducted "with or through" any U.S. person or entity (including a U.S. counterparty to the trade), except in limited circumstances. Second, it limits international banks' trading with the foreign operations of U.S. financial institutions and other U.S. companies, because the TOTUS exemption effectively requires the international bank to obtain representations from its foreign customer that none of

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its intermediate holding company ("IHC") rule. See 12 C.F.R. § 252.153 (excluding 2(h)(2) Companies from the IHC requirement); 77 Fed. Reg. 76628, 76638 (Dec. 28, 2012) ("The current proposal would not require foreign banking organizations to hold section 2(h)(2) investments under the U.S. intermediate holding company because these commercial firms have not been subject to Federal Reserve supervision, are not integrated into the U.S. financial operations of foreign banking organizations, and foreign banking organizations often cannot restructure their foreign commercial investments.").

39 See, e.g., 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("[Section 13(d)(1)(H) and (I) of the BHCA] recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law."); Letter from Sens. Jeff Merkley and Carl Levin at 43 (Feb. 13, 2012) ("[T]he purpose of [BHCA Section 13(d)(1)(I)] is to advance international comity and allow foreign firms to engage in activities permitted under foreign laws, while reducing risk in U.S. banks and protecting U.S. financial stability.").

the U.S.-based personnel of the customer's affiliates are involved in arranging, negotiating or executing the trade. Neither of these restrictions is relevant to the risk the international bank's trading activities present to the U.S. financial system, provided that the international bank's activities as principal are booked outside of the United States.

Based on feedback from our members, we understand that these restrictions have caused some international banks to move key personnel involved in arranging, negotiating and executing trading to non-U.S. financial centers, thus harming U.S. financial sector employment and reducing efficiency by artificially separating trading personnel from the world's deepest and most robust financial markets. Many of our members have also curtailed trading with U.S. customers and counterparties and through U.S.-based financial intermediaries (because transactions with or through U.S. persons may still be covered by the Volcker Rule), thereby reducing market liquidity for U.S. market participants and market share for U.S. financial intermediaries. Based on feedback from our members, 40% report undertaking one or more of the following actions:

1. Terminating trades with U.S. clients;

2. Closing down U.S. business units;

3. Re-routing trades in inefficient ways in order to enable certain non-U.S. operations to comply with TOTUS;

4. Splitting customer relationships between multiple entities in order to isolate certain permissible activities in certain entities (even if the client would prefer a singular point of contact with the international bank); and

5. Restricting the use of certain U.S. trading venues.

Based on feedback from members that rely on the TOTUS exemption for one or more business units, almost all of those members indicated that they have had to terminate transactions with U.S. counterparties, and a significant majority indicated that they have had to reorganize business units to make the TOTUS exemption available. Almost all of these members indicated that they had to construct procedures, systems and/or complex filters to discern whether their clients should be treated as U.S. entities, requiring an inordinate amount of time and resources to be spent in discussions with clients in order to determine their status under the Final Rule. In particular, clients often fail to understand that the non-U.S. subsidiaries of U.S. entities are treated as "U.S. entities" under the Final Rule. Furthermore, of those institutions that rely on the TOTUS exemption, almost all respondents indicated that the use of the TOTUS exemption (and corresponding changes and controls) was primarily to eliminate the need to comply with the cumbersome ongoing compliance program (including a complex set of policies, procedures and controls to ensure the activities stay out of scope) and not for the purpose of engaging in true proprietary trading that the Volcker Rule is intended to prohibit.

More alarming, however, is the discovery by many of our members that, contrary to the stated intentions of Congressional policy makers, the TOTUS exemption is effectively unavailable to their organizations. Several of the largest international banks that provide significant market liquidity and trading counterparty opportunities have reported being unable to rely on the TOTUS exemption for <u>any</u> of their non-U.S. trading desks as a result of the interpretive uncertainty and/or reorganizations and operational changes required. Even for members who rely on the TOTUS exemption, which generally are smaller to medium sized international banks, in aggregate less than 50% of their non-U.S. trading desks can rely on the TOTUS exemption.

Therefore, the TOTUS exemption should be restated to exempt trading activity by any non-U.S. banking entity that (i) is not directly or indirectly controlled by a banking entity organized in the United States and (ii) books the trading position and associated risk as principal (including the financial obligation and ownership of, and any financing directly provided for, or risk or hedging related to, that position) outside the United States. The restrictions on U.S. personnel of the international bank or its counterparty arranging, negotiating and executing trades and on trades conducted with or through U.S. entities (including the foreign operations of U.S. entities) should be eliminated.

Under our recommendation, the financial risks and any losses resulting from trading activities relying on the TOTUS exemption would be borne by the international bank outside of the United States and subject to the activities limitations, capital requirements and other prudential requirements of their home (or host) jurisdiction. It would permit continuing trading in the United States by non-U.S. affiliates through long-standing affiliate relationships (such as through permissible Rule 15a-6 arrangements), or, where customary, direct market access by the non-U.S. affiliate that books the transaction outside the United States.

This change would satisfy the core policy objective of the Volcker Rule—to protect the U.S. financial system and U.S. banking organizations from the perceived risks of proprietary trading and associated risk of taxpayer bailout in the event of losses incurred from high risk trading exposure—while appropriately tailoring the Volcker Rule to preserve the ability of international banks to conduct their offshore activities in compliance with local law consistent with the Congressional mandate to limit overseas application of the Volcker Rule. Our proposed revision would also prevent the unnecessary expenditure of Agency supervisory and international bank compliance resources on non-U.S. activities of limited prudential interest in the United States and remove artificial impediments to U.S. bank and investor participation in global financial markets.

B. Eliminate the current presumption that each purchase and sale is deemed to be a proprietary trade absent an applicable exemption

One of the principal flaws in the Final Rule that led to its unnecessary and onerous compliance burdens is the presumption that all trading as principal is deemed to be impermissible proprietary trading unless a banking entity can prove that an exemption applies and, then, can prove compliance with the narrow exemption. This has led to the imposition of compliance policies, procedures and metrics on trading activities that were not proprietary trading prior to the advent of the Volcker Rule, and still do not constitute proprietary trading today, merely to "prove the negative". Examination under the Volcker Rule has only perpetuated this presumption with examiners asking how a desk knows that its general customer activity doesn't encompass some element of proprietary trading. This effort is misplaced and wasteful. As Federal Reserve Bank of New York CEO and President Dudley stated recently, most beneficial customer market-making activity "has an element of proprietary trading."[40]

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[40] See Dudley Remarks.

Application of this principle outside of the United States is a compliance burden multiplier for international banks' non-U.S. operations, substantially expanding the scope of operations that must determine whether their activities are in scope and, where necessary, whether a Volcker Rule exemption is available. This requires international banks to diligence and implement the Volcker compliance program to their non-U.S. activities, even if they do not involve proprietary trading within the conventional meaning of the words. Significant effort and ongoing cost is expended in analyzing every overseas business unit, determining whether such units may make use of the TOTUS exemption (and, as discussed above, finding out in a significant majority of cases that the business unit may not use TOTUS) or another exemption and when a full exemption is not available, applying the full compliance policies, procedures and, in many cases, metrics requirements associated with a permitted activity to the overseas unit.

Given the overall interpretive uncertainty and associated regulatory risk, feedback from a significant number of our members indicates that international banks have been required to rely on a permitted activity exemption and to apply the more cumbersome procedural and monitoring requirements associated with such exemption even for non-trading business units (such as "banking book" or treasury and funding business units).

To more efficiently and appropriately target the Volcker Rule to those trading activities and desks that create legitimate proprietary trading concerns, **the current presumption that each purchase or sale is deemed to be a proprietary trade unless demonstrated to be outside of the trading account or otherwise excluded from the definition of proprietary trading should be reversed.**

Instead, the Agencies should adopt a principles-based approach that shifts the presumption toward permissibility of activity undertaken as principal and perhaps recasts some of the current rule exemptions as safe harbors. This would give banking organizations more flexibility to provide beneficial market services in an efficient manner and reduce costs while still implementing Congressional intent. The original intent of the statute was to prohibit certain high-risk, short term speculative trading activities, not to regulate significant swaths of beneficial conduct. However, compliance with the Final Rule requires implementation of compliance programs that significantly interfere with the conduct of normal, permissible business. Instead of requiring banking entities to implement policies, procedures and metrics that try to address whether permissible market making, hedging or underwriting activities satisfy a specified set of regulatory conditions, **the rule should instead use a principles-based approach to narrowly define and prohibit impermissible proprietary trading activity** (with regard to which Chairman Volcker himself indicated "[y]ou know when you see it").[41] The Agencies have appropriate discretion to interpret the definition of "proprietary trading" and "trading account" to effect this recommendation without statutory change.

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[41] See, e.g., Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs, 111th Cong. 7, 14 (2010) (statement of Paul A. Volcker, Chairman, President's Econ. Recovery Adv. Bd.) ("Similarly, every banker I speak with knows very well what 'proprietary trading' means and implies. . . .Well, I think the only answer I can give there is like pornography. You know it when you see it.").

C. Expand the exemption for trading in foreign sovereign debt to permit trading to the same extent as U.S. government debt and to permit trading in derivatives on foreign government obligations

As currently written, the Volcker Rule's exemption for trading in non-U.S. sovereign debt is limited and ambiguous. As a result, it calls into question the ability of both U.S. and international banks to trade home and host-country sovereign debt without restriction. The current exemption takes a territorial approach—it provides some entities with exemptions for trading in the sovereign securities of the country in which the entity sits or, in some cases, the country in which the entity's parent sits. This narrow territorial approach fragments markets and segregates pools of liquidity. The exemption should be revised to ensure it does not interfere with the ability of U.S. and international banks to act as primary dealers, market-makers and liquidity providers out of local offices, out of regional hubs and on a global basis and to remove onerous market-making requirements that do not apply to these banks when trading U.S. sovereign debt.

Sovereigns need the liquidity that global banks (whether headquartered in or outside the United States) can provide. Many international banks and U.S. banking organizations serve as primary dealers to multiple sovereigns. In some cases, banking organizations that are subject to the Volcker Rule due to their U.S. operations are the principal intermediaries through which government financial and monetary policies operate. They also play critical roles as underwriters, market-makers and liquidity providers for sovereign, state, provincial and municipal debt issuances. Restrictions on the ability of banking organizations to continue to serve these critical liquidity provision, investment and intermediary roles harm the governments they serve and make those U.S. and non-U.S. banking organizations less competitive in those markets than other banking organizations that do not have U.S. operations and therefore are not subject to the Volcker Rule's complex regulatory scheme.

As a result of the territorial approach described above, both U.S. banking organizations and international banks are currently required to segregate their trading activities among multiple exemptions—such as the narrow sovereign debt exemption, the TOTUS exemption and the more onerous exemptions for market-making and underwriting activities—that fail to efficiently cover all types of purchases and sales of sovereign debt across all affiliates and that impose a variety of restrictions, limitations and compliance burdens. For example:

- Ambiguities in the guidance provided in the Preamble as to which entities and branches within an international bank's affiliated group can transact in which sovereign securities outside the Volcker Rule has caused many international banks to rely on a patchwork of other exemptions. If a non-U.S. branch of an international bank trades sovereign debt with a non-U.S. counterparty, it may be able to rely on the TOTUS exemption, but if it were to trade with a U.S. counterparty, it might need to comply with the Volcker Rule's market-making exemption, which would require adopting a complex and burdensome compliance, metric analysis and reporting framework.

- Certain foreign subsidiaries of a U.S. banking organization can trade in the sovereign debt of the country in which that subsidiary is located, but a regional hub outside of that country (e.g., a London regional hub seeking to trade other European sovereign debt) and the parent banking organization in the United States cannot rely on this formulation of the foreign sovereign debt exemption and would therefore need to comply with the more onerous market-making or underwriting exemptions to trade in the same sovereign debt instrument.

As a result of the interpretive issues described above, at least 60% of our members who discussed the issue with us found that the non-U.S. sovereign debt exemption was unworkable and too limited and therefore do not have any desks that rely on such exemption to trade sovereign debt.

The Agencies should expand the regulatory exemption for trading in non-U.S. government securities. The simplest solution would be a blanket exemption for all sovereign debt trading (the way that trading in U.S. government securities is exempted). Such an exemption should also allow for the trading of derivatives on non-U.S. government securities.

An expanded exemption for sovereign debt would level the playing field for U.S. and international banks, facilitate more efficient sovereign debt trading operations and remove an irritant to foreign governments that discourages cooperation in international negotiations. The different levels of risk associated with different types of sovereign debt can be addressed in a more nuanced manner through risk-based capital and other prudential and supervisory requirements.

D. Categorically exempt activities and business units subject to banking book regulatory capital and accounting treatment from the definition of proprietary trading and, in particular, provide a categorical, principles-based exemption for treasury, funding, ALM and similar functions

One method of addressing, in part, the broad presumption of the Final Rule that all trades are proprietary trades unless specifically exempted (see Section III.B above) would be to clarify the scope of the "trading account" definition. In an apparent attempt to ensure that almost all transactions in securities, derivatives, futures and options would be deemed proprietary trading *ab initio*, the Final Rule includes three different methods, as well as an embedded rebuttable presumption, for capturing transactions in financial instruments under the Volcker Rule. The scope of the "trading account" definition is therefore the primary gateway through which the overall proprietary trading presumption, and the need for many banking entities to "prove the negative", operates.[42]

The trading account does not, in fact, capture only those transactions that traditionally have been observed as "trading". At least two of the prongs of the definition are largely unworkable and, primarily because of their ambiguity, contribute significantly to the breadth of the definition.

The first prong—known as the "purpose test"—requires analysis of whether the transaction was entered into by the banking entity with the intent to profit based on short-term price movements. However, trading intent is highly subjective and it is difficult, if not impossible, to document whether the motive of a transaction was to profit from short-term price movement. The subjectivity of this test, and banking entities' wariness of the Agencies' reluctance to exclude transactions from the scope

42 Indeed, the definition of "proprietary trading" is simply "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments." Final Rule § ___.3(a). The problematic nature of the three-pronged definition of "trading account" is widely known, including criticism and recommendations for change in the Treasury Report. See Treasury Report at 74-75.

of the Volcker Rule, have led banking entities to assume that many transactions in financial instruments are covered, whether or not such activity had previously been viewed as trading.

The Agencies, on the other hand, apparently understood the purpose test's subjectivity, and bolted a presumption of trading intent on to this definition—a purchase or sale of a financial instrument will be presumed to be for the trading account if the banking entity holds the financial instrument for fewer than 60 days or substantially transfers the risk of the position within 60 days. This timing presumption is blunt, to say the least, and does little to serve as a proxy for trading intent.[43] Rather, it serves primarily to widen the net for subjecting transactions to the Volcker Rule restrictions and to shift the burden to banking entities to justify their transactional activity without creating any additional clarity as to the Volcker Rule's true purpose. Although the presumption is supposed to be rebuttable, many of our members have found the rebuttal of the presumption unworkable in practice because no clarity has been provided by the Agencies as to what rebuttals will be sufficient to satisfy a banking entity's burden to overcome the presumption. In fact, many banking entities were informed by one or more Agencies over the last 3 years that they should not use the rebuttal, notwithstanding its clear availability in the Final Rule. We also understand that staff of the Agencies has informed several banks that they should not attempt to craft a categorical rebuttal for repeated transactions that should be outside the scope of the Volcker Rule. In short, then, the presumption pulls in large numbers of "false positive" trades, and the ability to rebut is either discouraged or unused.

The third prong—known as the "dealer status test"—requires a determination of whether the trading activity is being conducted by a securities or swaps dealer "in its capacity as a [securities or swaps] dealer." This test is not workable on a global scale and inadvertently captures many non-U.S. banking entities (and presumptively all of that entity's transactions). There is no global definition of "dealing", no international regulatory consensus as to what types of activities require registration as a dealer outside the United States and no understanding how the status test applies to "universal" banks that engage in many activities within one entity, including based on powers or licenses that provide securities and swaps authority as part of their banking authorization. Thus, international banks subject to the Volcker Rule, as well as U.S. banking organizations with operations outside the United States, have substantial difficulty in determining that transactions by financial entities outside the United States can be outside the trading account.[44]

We would like to focus our comments on one important practical consequence of the attempt to capture all transactions through this multifaceted trading account definition—the breadth of the trading account definition has created significant uncertainty with regard to the applicability of the

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43 For example, staff of the Agencies went on to expand, through oral interpretation, the scope of the trading account by informing many banking entities that the following transactions would trigger the 60-day presumption, *regardless of intent of the transactors*: (1) transactions in instruments that by their initial terms were less than 60 days (e.g., purchasing a 30-day note, even if the intention is to hold to maturity, or entering into a 45-day interest rate swap), and (2) transactions in originally longer-dated instruments that have less than 60 days remaining until maturity (e.g., purchasing a 5-year note one month before its maturity, even if the intent is to hold until such maturity).

44 Even for U.S. registered securities or swap dealers, the Agencies' informal examination advice has increased the breadth of this definition. Many institutions have been told that *all transactions* within a securities or swap dealer should presumptively be deemed part of the trading account, notwithstanding language of the Preamble to the contrary. See Preamble at fn. 135 and accompanying text.

Volcker Rule to traditional banking activities, such as hedging related to lending and deposit taking; treasury, ALM and funding activities; and transactions in relation to a bank's own financing issuances. In particular, as discussed further below, the trading account definition is the primary reason why treasury, funding and ALM activities have had to layer additional policies and procedures on their activities, which perversely results in a tangible decrease in the safety and soundness of those operations. All of these activities are subject to "banking book" regulatory capital and accounting treatment and should be clearly outside the "second prong" of the trading account definition—the market risk capital rule test—but the ambiguity and breadth of the other two tests and related 60-day presumption cause banking entities and/or Agency supervision staff to include many of these transactions and business units within the scope of the Volcker Rule's compliance requirements.

Therefore, regardless of how the purpose test, the dealer status test and the 60-day rebuttable presumption are addressed in the context of our points in this Section and Section III.B. on the unwarranted presumption that all transactions in financial instruments are captured in the trading account, **the Agencies should clarify that activities and business units subject to banking book regulatory capital and accounting treatment are categorically permissible and should not be deemed proprietary trading.**

As the chief example of the inappropriate scope of the Final Rule's proprietary trading restrictions, banking organizations' traditional treasury, funding and ALM functions have had to implement burdensome compliance infrastructure, policies and procedures in a manner harmful to their safe and sound operation. Effective funding, treasury and ALM operations are vital to a banking organization's ability to remain safe and sound, while also extending credit to clients and participating in the U.S. financial markets. There is no good reason to treat these activities as potential sources of proprietary trading. Indeed, the FSOC Volcker Study specifically observed that "ALM activities are clearly intended to be permitted activities, and are an important risk mitigation tool. . . . A finding that these are impermissible under the Volcker Rule would adversely impact liquidity and interest rate risk management capabilities as well as exacerbating excess liquidity conditions. These activities also serve important safety and soundness objectives."[45]

Risks in a treasury function are typically hedged, managed and supervised in ways that should significantly mitigate any financial stability concerns. There should be no need to capture these business units inappropriately within the restrictions of the Volcker Rule. Despite this, when these activities are captured within the trading account definition, the Final Rule layers on additional, specific, prescriptive compliance burdens and restrictions (under, e.g., the liquidity management and hedging exemptions)[46] that make it harder for banking organizations to fund and manage risk in their general business activities efficiently and centrally through treasury and financing functions. This, in turn, reduces availability and raises costs of lending and other intermediation and market services. The FX Funding Transactions described in the next section are only one example of the issues raised by the lack of a comprehensive exclusion for treasury, funding and ALM functions.

Based on feedback from our members, almost all members have business units that are treated as "banking book" units for purposes of regulatory capital and accounting purposes (typically

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45 FSOC Volcker Study at 46.

46 See Final Rule §§ ___.3(d)(3), ___.5.

those units that handle internal funding, treasury and ALM) and that do not "trade" or raise concerns about engaging in "dealer" activity, but that are nevertheless relying on a permissible activity exemption (such as risk-mitigating hedging), rather than being categorically excluded. To address this issue, international banks have had to impose trading infrastructure, monitoring and reporting on non-trading desks in a manner never previously required. Such business units ironically engage in the most innocuous of transactions (i.e., those that are meant to enhance the safety and soundness of the bank, such as managing interest rate risk or ensuring sufficient funding and liquidity for the organization, including often intracompany movements of funds). Members report that the application of the more burdensome exemptions to such business units has often been driven by individual feedback from one or more of the Agencies, either because the Agency was unwilling to sign off on the business unit being excluded from the scope of the Final Rule or because the Agency took very rigid views as to the applicability of certain provisions of the Final Rule (e.g., tripping the 60-day rebuttable presumption because a hedge was executed against a liquidity pool).

Several of our members that have gotten comfortable with a determination that certain of these treasury or funding activities may be long-term and "outside of a trading account" nevertheless need to observe policies and procedures related to the 60-day rebuttable presumption. Several of our members reported that the rebuttal process is unworkable, and therefore they have found that only a more burdensome exception such as risk-mitigating hedging may be available. However, even for those institutions that reported use of procedures for the 60-day rebuttal, the procedures surrounding the rebuttal generally add layers of approvals, controls and documentation to otherwise safe and sound transactions, such as hedging, and force artificial boundaries and transaction longevity/holding period procedures that may not be consistent with prudent or efficient risk management.

In addition, based on feedback from members, it appears that more than 50% of our members have had to make changes to business units that engage in funding the organization (including those engaged in securities issuance to the market) because of the Volcker Rule. In addition to the burdensome application of risk-mitigating hedging policies, procedures, systems and metrics to a number of these business units, significant issues reported include: having to shift counterparties for hedging of funding or of USD liquidity, typically away from U.S. counterparties and funding sources; inefficient bifurcations of management of short-term funding/liquidity (often to be able to use TOTUS or the 60-day rebuttal) from long-term funding/liquidity management; inefficient geographic bifurcations of treasury/liquidity/FX management (also often in an attempt to isolate treasury/funding/ALM operations within the United States, which are more likely to trigger applicability of the Volcker Rule); imposition of artificial longevity requirements (so as not to trigger the 60-day rebuttal) even if such requirements do not comport with desired asset-liability management; among others.

The Final Rule should be revised to provide a categorical, principles-based exemption for treasury, funding, ALM and similar functions from the Volcker Rule.

The current liquidity management exemption is too narrow (e.g., applying only to securities and not to derivative or other risk management tools) to address the full scope of a banking organization's treasury, funding and ALM functions and imposes unnecessary compliance burdens and restrictions on those activities that could use the exemption. As stated above, there are more efficient tools for ensuring that these activities are conducted in a safe and sound manner. A categorical, principles-based exemption for these traditional and important functions would remove inefficient compliance burdens on both international banks and U.S. banking organizations, thereby permitting them more effectively to provide financing and liquidity in global markets.

E. Exclude FX Funding Transactions from the definition of proprietary trading

One area of particular concern for international banks' treasury and liquidity management functions is how the Volcker Rule affects the use of FX Funding Transactions (i.e., cross-currency swaps, FX funding swaps and other common cross-currency financing transactions). FX Funding Transactions are critical to a global (both U.S. and non-U.S.) banking organization's ability to efficiently provide cross-border funding for loan originations, asset purchases, collateral/margin payments and movements and the payment of obligations, among other things. FX Funding Transactions are necessary to ensure that funds can be deployed within a global banking group where they are needed in the appropriate currency. They provide an important mechanism for international banks to efficiently fund their U.S. operations and investments and for U.S. banking organizations to efficiently fund their foreign operations.

FX Funding Transactions are ordinary course funding transactions that are the functional equivalent of a loan or repurchase agreement, e.g., a purchase of X currency with Y currency, coupled with an agreement to repurchase Y currency in the future with X currency. Their purpose is not to profit from short-term price movements or hedge other trading positions but to fund an asset or other payment obligation or liquidity need in a specified currency. Excess home office liquidity (say, USD for a U.S. bank or JPY for a Japanese bank) can be converted on a short term basis to take advantage of this excess liquidity or cheaper funding to fund operations in other currencies.[47] Within the industry, these FX Funding Transactions are not viewed as derivative trading transactions. However, the "form" of the transactions (often using swaps documentation) has diverted attention away from their true substance as financing transactions and raised questions about whether FX Funding Transactions are subject to the Volcker Rule. Discussions with the Agencies over the last three to four years have not resulted in definitive guidance that these transactions should be exempted under the Volcker Rule.[48]

These transactions are typically initiated by the treasury and liquidity management functions of a banking organization and would generally be subject to monitoring and restrictions based on the organization's liquidity risk management procedures, applicable laws and regulations (which may include the applicable liquidity coverage ratio) and/or applicable supervisory and examination guidance. Therefore, other tools are available to monitor and ensure the safety and soundness of the ALM, treasury and financing activity, rather than applying the Volcker Rule inappropriately to these activities.

FX Funding Transactions that are the functional equivalent of currency repurchase agreements or lending transactions should be excluded from the definition of proprietary trading, just as loans and repurchase agreements have been excluded in the Final Rule. Excluding FX Funding Transactions would allow both U.S. and non-U.S. banking organizations to provide lending and other beneficial services inside and outside of the United States in an efficient manner.

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47 Other pockets of liquidity outside a bank's home country can also be used in this way.

48 Indeed, a staff member of one of the Agencies even publicly discussed that the Agencies were thinking about how the Agencies should address an FAQ toward FX Funding Transactions at an industry conference in the spring of 2015, but no interpretation or clarity was forthcoming.

F. Clarify that riskless principal derivative transactions are exempt from the Volcker Rule

Section ___.6(c)(2) of the Final Rule provides that the proprietary trading prohibition shall "not apply to the purchase or sale of financial instruments by a banking entity acting as riskless principal". Notwithstanding the broad application of this exclusion to "financial instruments", concerns have been raised about ambiguity in its application to transactions in back-to-back matching derivatives.

"Customer access" business units make use of back-to-back matching derivatives and often do so in cross-border transactions. These businesses are typically private banking, wealth management or otherwise remote branch locations that are not provided any internal limits to manage risk within their business units and are therefore required to perfectly match any customer transaction with an internal back-to-back transaction to the market-making desk that manages the risk of such transactions. By perfectly matching the transactions to the risk-management "hub", there should be no basis risk retained by the customer-facing business unit and market risk should be flat, thus making most metrics meaningless (including the customer-facing trade ratio which typically also will be perfectly split). The risk-management "hub" will be designated as (typically) a market-making desk, will have taken into account all of the customer-access business units when calculating its reasonably expected near-term demand and will supply the Agencies with metrics if applicable. Therefore, the Agencies should not be "missing" any transactions or data that they deem should be captured by the Volcker Rule. Furthermore, the Volcker Rule is designed to address market risk of speculative behavior and these transactions eliminate market risk for the business unit, which is engaged in customer-driven activity.

Another example of the use of back-to-back matching derivatives is in the context of non-U.S. derivative clearing models. The general model for clearing agents in the U.K., the EU and certain other countries is a back-to-back, principal-to-principal model, whereas the U.S. model typically involves clearing agents or futures commission merchants acting as agents with a guarantee of the customer's obligations. This difference in market conventions should not result in a difference in how the Volcker Rule applies to an activity recognized by legislatures and regulators worldwide as being critically important to the reform agenda.

The Agencies should clarify that back-to-back matching derivatives may rely on the riskless principal exemption in § ___.6(c)(2).

G. Exclude identified banking products and participations in certain identified banking products from the definition of "financial instrument"

Our members have raised with us a variety of ambiguities related to transactions in traditional non-derivative banking and credit intermediation instruments. These ambiguities have created uncertainty in international transactions, and in particular international trade contracts.

The Final Rule's definition of "financial instrument" excludes loans, most commodities and foreign exchange or currency.[49] While the definition of "loan" is helpful in including "any loan, lease, extension of credit, or secured or unsecured receivable", it requires that the instrument not be a

[49] Final Rule § ___.3(c)(2).

security or a derivative.[50] There are traditional banking and credit intermediation instruments for which ambiguity exists as to whether the instrument may be a security or a derivative.

In international trade contracts and other bank financing of payments owed by one business to another upon receipt of shipment of goods, banks have historically provided letters of credit, bankers acceptances ("BAs") and bills of exchange ("BoEs") (and also risk participate with other banks in each of these products). These instruments could be deemed financial instruments because (i) in the case of BAs and BoEs, they can and do have tenors greater than 9 months, which under the Securities Exchange Act definition of "security" could be deemed securities, even though in substance banks' transactions in these instruments are purely related to lending activities, and (ii) banks also buy and sell participations in these instruments as a way to manage and distribute risk.

This ambiguity has caused some of our members either not to trade or participate in the instruments or to limit types of products offered to customers. These decisions can have a detrimental impact on industry lending and international trade flow.

We note that the definition of "derivative" in the Final Rule excludes non-swap "identified banking products", which include deposit accounts, savings accounts, certificates of deposit or other deposit instruments; BAs; letters of credit and loans; debit accounts under credit cards or similar arrangements; and participations in loans.[51] We believe this exclusion should be extended to the financial instrument definition. Identified banking products are sufficiently different from securities and derivatives because they have traditionally served as the basic instruments for banks' roles as funding and credit intermediaries in the global economy. This difference was recognized in both the federal securities laws and the Commodity Exchange Act as sufficient to exempt banks transacting in such products from being deemed a broker-dealer, swaps dealer or security-based swaps dealer.[52]

The Agencies should exclude identified banking products and participations in identified banking products from the definition of "financial instrument".

IV. Funds Issues

A. Replace the current definition of covered fund with an activities-based definition focused on covered funds that are engaged primarily in short-term proprietary trading

The Volcker Rule's statutory text defines hedge funds and private equity funds as issuers that rely on the specific exemptions from the Investment Company Act of 1940 (the "1940 Act") contained in Sections 3(c)(1) and 3(c)(7) of that Act ("3(c)(1)/3(c)(7) Funds"), "or such similar funds as the [Agencies] may, by rule . . . determine".[53] In the Final Rule, the Agencies adopted a definition of "covered fund" that includes all 3(c)(1)/3(c)(7) Funds, plus certain additional funds that the Agencies

50 Final Rule § ___.2(s).

51 See Final Rule § ___.2(h)(2)(ii); 15 U.S.C. § 78c note.

52 See 15 U.S.C § 78c(a)(4)(B)(iii)(I) and (ix) (exemption from broker definition); 15 U.S.C. § 78c(a)(5)(C)(iv) (exemption from dealer definition); 7 U.S.C. § 27a (exemptions from swap and security-based swaps definitions).

53 12 U.S.C. § 1851(h)(2) (emphasis added).

believed were substantially similar to 3(c)(1)/3(c)(7) Funds, and provided exclusions for certain types of vehicles that the Agencies deemed should not be viewed as covered funds. [54]

Sections 3(c)(1) and 3(c)(7) of the 1940 Act are broadly utilized exemptions from registration as an investment company for issuers that either have fewer than 100 beneficial owners or that are owned exclusively by sophisticated investors (e.g., "qualified purchasers" as defined in the 1940 Act). Hedge funds and private equity funds commonly rely on these exemptions but so do many other vehicles that are not private equity funds or hedge funds as commonly understood and in particular include entities that engage in no meaningful securities trading activity.

Since the Final Rule was released, our members have estimated that they have had to diligence and document hundreds of thousands of entities in order to determine whether they were covered funds. Of these entities, members indicated that typically only 3.6% of assessed entities are identified as covered funds. Most members indicated that they have either developed internally or purchased from a third-party vendor a system to assist them in assessing and documenting entities for covered fund status. The key, however, would be to reduce *ab initio* the number of entities that actually need to be reviewed as an ongoing matter or that are inadvertently captured as covered funds by creating a definition designed to focus on the much narrower goal of the Volcker Rule.

The statutory text provides the Agencies with an alternative approach—to define a class of "similar funds" by regulation. This alternative could have more closely followed the original intent of the fund provisions to address short-term proprietary trading activities that might be conducted indirectly through fund vehicles. But the Agencies' approach has thus far resulted in an overly broad definition of covered fund that goes well beyond the original intent of Congress, and the list of enumerated exclusions fails to exclude many vehicles that do not represent indirect short-term trading by a banking entity (or even traditional private equity funds or hedge funds). For example, as currently crafted:

- Foreign mutual funds offered to retail investors outside of the United States that have also been sold in private placements in certain jurisdictions, including the United States, are treated as covered funds unless they meet the specific exclusion for "foreign public funds" under the Final Rule. Such a definition is far more complex and restrictive than necessary and requires substantial diligence on funds sold outside the United States, and analysis of foreign fund structures through the lens of U.S. fund regulations, to attempt to

54 See 79 Fed. Reg. at 5670-71 ("The Agencies believe that the language of section 13(h)(2) [of the BHCA] can best be interpreted to provide two alternative definitions of the entities to be covered by the statutory terms 'hedge fund' and 'private equity fund.' Under this reading, the first part of section 13(h)(2) [of the BHCA] contains a base definition that references the noted exclusions under the [1940 Act] (the 'default definition'), while the second part grants the Agencies the authority to adopt an alternative definition that is triggered by agency action (the 'tailored definition'). Thus, if the Agencies do not act by rule, the definition is set by reference to the [1940 Act] and the relevant exclusions alone; if the Agencies act by rule, the definitions are set by the Agencies under that rule. . . . Further, the Agencies believe that the provision permits them to tailor the scope of the definition to funds that engage in the investment activities contemplated by section 13 (as opposed, for example, to vehicles that merely serve to facilitate corporate structures); doing so allows the Agencies to avoid the unintended results, some of which commenters identified, that might follow from a definition that is inappropriately imprecise.").

determine whether a fund may qualify. In contrast, U.S. mutual funds are exempt merely by registering as U.S. investment companies.

- Many privately placed U.S. and non-U.S. securitizations are deemed covered funds unless they meet the narrow exclusion for "loan securitizations" in the Final Rule. In conjunction with capital and risk retention rules, the Volcker Rule's treatment of securitization vehicles as covered funds has been a major contributor to the anemic progress towards reviving the securitization markets, which has had a knock-on effect on capital formation and the ability of financial institutions to lend efficiently.

- The Volcker Rule illogically prohibits banks from doing indirectly, through a special purpose entity, what it would be permissible to do directly. For example, special purpose vehicles created to hold securities, to facilitate collateral posting, margin lending or other securities financing or to comply with foreign laws regulating ownership of securities (e.g., local ownership requirements in some jurisdictions) may be deemed to be covered funds, and therefore banking entities may be restricted from holding investments in such vehicles even though an investment by the banking entity in the underlying securities would be permissible.

The Agencies should replace the current definition of covered fund with an activities-based definition that is limited to 3(c)(1)/3(c)(7) Funds that are engaged primarily in short-term proprietary trading, thereby implementing the original purpose of the Volcker Rule's fund provisions—i.e., preventing evasion of the proprietary trading prohibition and certain private fund activities deemed to be overly risky. This alternative approach is permitted by the reference to "such similar funds" in the statutory definition of "hedge fund" and "private equity fund".

A revised approach to defining "covered fund" would eliminate many of the unintended effects of the Volcker Rule on a variety of securities holding and investment vehicles that are not private equity funds or hedge funds and do not create the proprietary trading risks at which the Volcker Rule was targeted. It would expand investment opportunities for U.S. investors, support lending, capital formation and other beneficial economic activity and ensure the Volcker Rule's restrictions are appropriately tailored to its core policy concerns. Further, providing an activities-based approach would substantially alleviate the compliance burden to diligence and document entities with which the banking entity has a relationship (either through ownership, sponsorship, lending or other services) by focusing on the intended scope of entities (i.e., entities that engage in short-term trading of financial instruments for their own profit).

B. Exclude controlled funds (e.g., foreign public funds or private funds solely offered outside the United States) from the definition of banking entity

The Agencies used their discretion to exclude a number of types of funds and similar vehicles from the definition of "covered fund".[55] These exclusions include, among other vehicles, foreign public funds that meet certain criteria, loan securitizations that meet narrowly defined criteria, employee securities companies and U.S.-registered investment companies. For international banks, "foreign private

55 See id.

funds" (also known as "foreign excluded funds") that have no U.S. investors generally also fall outside the definition of a covered fund.[56]

Unfortunately, the utility of these exclusions was undermined by the way the Final Rule defines the entities that are themselves subject to the Volcker Rule's prohibitions. While international banks may invest in and sponsor these excluded funds, the entities may themselves become "banking entities" subject to the Volcker Rule's proprietary trading and covered fund restrictions if they are "controlled" by a banking entity for purposes of the BHCA. This is due to the fact that the Final Rule carves out "covered funds" from the definition of "banking entity" but does not provide a similar carve-out for other types of funds that are not "covered funds" due to an exclusion or exemption. As a result, the operations of controlled foreign private funds and other exempt funds are restricted in an unintended, back-door fashion—for example, where an international bank serves as general partner of a non-U.S. hedge fund it offers to its non-U.S. clients, that hedge fund's trading ends up subject to the Volcker Rule's prohibitions. Under the Final Rule, this would, practically speaking, require such a hedge fund to comply with the TOTUS exemption, precluding, for example, trading with U.S. counterparties.

This result unreasonably restricts the investment and trading activities that international banks conduct on behalf of their investors and frustrates the core purpose of the exemptions—including, among others, allowing international banks to provide traditional asset management services to investors outside the United States. It would be inconsistent to impose greater restrictions on foreign funds that are excluded from the definition of "covered fund" due to their lack of U.S. contacts than on U.S. and non-U.S. funds that are covered funds (and thus not banking entities). Similar issues arise for many other types of funds (U.S. and non-U.S.) that are specifically excluded from the definition of covered fund under the Final Rule. It could not have been intended that funds deliberately excluded as covered funds were meant to be drawn back in merely based on their permissible relationships with banking entities.

Resolution of the foreign private fund issue in particular is extremely important to our international member banks, many of whom have extensive non-U.S. investments and asset management businesses that would be significantly affected if they were required to apply the Volcker Rule's proprietary trading and covered fund restrictions to foreign private funds. For many of these structures, local law imposes certain governance arrangements or structures that create controlling relationships under the BHCA. In a survey we conducted in September 2014, 18 respondent banks reported 2,313 foreign private funds that they are deemed to "control" for purposes of the BHCA and thus could be considered banking entities.[57] A 2015 European Banking Federation ("EBF") survey of members revealed that eight of the 11 respondents expected severe or significant impacts on their non-U.S. asset management business because controlled foreign private funds may also be deemed "banking entities". These eight institutions reported, in aggregate, in the range of 8,600 to 19,500 sponsored foreign funds.[58]

[56] See Final Rule ___.10(b)(iii) (including foreign funds that have been exclusively been offered outside the United States in the definition of covered fund only with respect to U.S. banking entities).

[57] See, e.g., IIB Letter to Scott Alvarez (Sept. 12, 2014) (the "IIB Letter").

[58] See, e.g., EBF Foreign Funds Advocacy Survey Responses (June 2, 2015) (submitted to the Volcker Rule Working Group, June 19, 2015).

We and other trade associations and individual banks have raised this issue with the staffs of the Agencies on numerous occasions over the last three to four years.[59] We appreciate that the Agencies in July of this year acknowledged the issue with respect to foreign private funds and provided temporary relief (until July 21, 2018) for many such funds.[60] However, the temporary relief is too restrictive, as it includes a condition that the foreign excluded fund be offered in connection with a "bona fide asset management business".[61] A final, permanent resolution, without the asset management requirement,[62] is instead needed to provide certainty to international banks' ongoing non-U.S. fund businesses, and similar problems with respect to other exempt funds are still not addressed. The Agencies have adopted other exclusions from the banking entity definition through regulation and guidance[63] and have the authority to address this issue in a revised regulation without statutory change.

Controlled, bona fide investment funds (pooled investment vehicles and managed accounts) excluded from the definition of covered fund because they are organized and offered outside of the United States should be excluded from the definition of banking entity, just as covered funds are excluded.

A similar exclusion should be provided for funds that are organized and offered pursuant to another exclusion from the definition of covered fund (e.g., foreign public funds, loan securitizations, registered investment companies, employees' securities companies, etc.).

C. Revise and clarify the foreign public fund exclusion

While the Final Rule excludes certain "foreign public funds" from the definition of covered fund where the fund has been offered or sold predominantly to retail investors outside the United States (allowing for a limited private placement in the United States), certain of the conditions that are required to meet the definition are ambiguous and require information which is often extremely burdensome (or impossible) to ascertain, particularly when the fund is sponsored, advised or distributed by third parties. In particular, to qualify, a foreign public fund must, among other requirements, be authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction and must sell ownership interests predominantly through one or more public offerings outside of the United States. These conditions create—even when a fund is publicly registered—a complicated, fact-specific assessment about the manner and extent in which the fund has actually been offered to or held by the public at various stages of its existence, thereby limiting the utility of the exclusion. Particularly with respect to unaffiliated funds, a banking entity's information regarding the empirical, as well as future,

59 See, e.g., IIB-SIFMA Letter to Scott Alvarez (July 1, 2015); Letter from the EBF, Japanese Bankers Association, Canadian Bankers Association and Australian Bankers' Association to the Volcker Rule Working Group (June 9, 2015); IIB-SIFMA Letter and Outline to the Volcker Rule Working Group (May 20, 2015); Letter from SIFMA to Scott Alvarez (Oct. 20, 2014); IIB Letter.

60 See Foreign Fund Guidance.

61 See id.

62 International banks may, in addition to asset management for customers, find these local structures efficient in facilitating funding, risk management, collateral posting, liquidity management, as well as other customer transactions.

63 See supra fn. 34.

marketing efforts will be very limited. As a result, banking entities have to request representations from unaffiliated investment advisers as to whether their fund qualifies for the foreign public fund exclusion, requiring substantial diligence by both the banking entity and the fund's manager, as well as potentially multiple third-party distributors.

It would be more efficient to defer to the regulation of the home country jurisdiction or a principal foreign market where the fund is offered regarding whether the fund is appropriate for sale to retail investors.[64] Such an approach would provide greater certainty with respect to the status of the foreign public fund, particularly where the international bank is serving as a market maker in the fund's interests. For example, under the Final Rule, even certain funds that are available to the public by virtue of being listed and traded on a retail-level stock exchange may not qualify as a foreign public fund as the definition of "public" is linked to the primary public distribution. The U.S. securities laws recognize a company as public if it is registered under the Securities Exchange Act, irrespective of its manner of primary distribution. A revised definition that looks to the fund's qualification as eligible for sale to retail investors would provide for similar recognition for foreign funds that are listed and actively traded on a foreign public stock exchange.

One large institution has indicated to us that they currently treat over $100 million in securities as interests in covered funds as a result of the lack of information and interpretive uncertainty surrounding the foreign public fund exclusion, despite the funds' public status under local law.

The foreign public fund exclusion should be revised to focus on the qualification of the fund in its jurisdiction of organization or principal foreign markets as eligible for retail sales, similar to the Volcker Rule's treatment of registered investment companies in the United States, rather than imposing specific conduct requirements based on the manner of the fund's primary offering.

D. <u>Foreign banks should be permitted to hold investments in foreign securitizations mandated by non-U.S. risk retention rules</u>

In certain non-U.S. jurisdictions, banking entities are required to hold a certain percentage of the non-U.S. securitization in order to comply with the risk retention rules. Requirements in non-U.S. jurisdictions may be in excess of the limits permitted under the Final Rule, which are tied solely to U.S. risk retention requirements. Allowing banking entities to hold investments in order to comply with foreign law is entirely consistent with the policy purposes of the Volcker Rule, as the investment functions only as a legally mandated mechanism to align the sponsor of the securitization with investors by providing "skin in the game".

Banking entities should be permitted to hold investments in non-U.S. securitizations that are covered funds to the extent mandated by non-U.S. risk retention rules, just as banking entities are permitted to hold investments in U.S. securitizations to comply with U.S. risk retention rules.

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64 It is relatively common outside the United States for a fund to be organized in one jurisdiction, but principally sold in another jurisdiction, including in some cases being listed for sale on a foreign public stock exchange in another jurisdiction.

E. The aggregate 3% limit should be calculated based on global Tier 1 capital, not capital at the IHC level

The Agencies should confirm that, when calculating the aggregate investment limits for covered fund investments held by international banks required to establish a U.S. IHC, an international bank's aggregate limit should be calculated on its global Tier 1 capital, and the aggregate limit should not be applied at the IHC level based on the Tier 1 capital of the U.S. IHC. This treatment ensures equivalent treatment for U.S. and foreign banking entities.

Section ___.12(c) of the Final Rule prescribes methodologies for calculating the 3% Tier 1 aggregate limit (the "aggregate limit") applicable to certain ownership interests in covered funds. Generally, U.S. banking organizations may calculate the aggregate limit with reference to the Tier 1 capital of their top-tier parent entities, other than with respect to ownership interests held under subsidiary insured depository institutions. Although the aggregate limit provisions of Section ___.12(c) present a good deal of interpretive complexity as drafted, the provisions can be read to impose comparative disadvantages on FBOs required to establish U.S. IHCs by virtue of requiring those FBOs to calculate the aggregate limit at the IHC level for ownership interests in covered funds held under the IHC. Imposing a substantially smaller Tier 1 capital base on FBOs (i.e., that of an IHC) for purposes of the aggregate limit is inconsistent with the principle of competitive equality embodied in the Volcker Rule with respect to activities undertaken in the United States.

F. Narrow the name-sharing prohibition

U.S. banking organizations and international banks have both been required to engage in a costly effort to rename their covered funds so that the group name and the name of affiliates or subsidiaries are not used in the name of the covered fund. This has been an expensive, unnecessary and opaque exercise that runs counter to a core financial reform goal of boosting transparency for investors. It is particularly inefficient when applied to an international bank that has numerous global affiliates with no contact to the United States. In addition, to the extent that covered funds are limited to private equity and hedge funds, investors in such funds are sophisticated and able to discern that the mere sharing of a name as a marketing tool does not denote an implicit guarantee of the entity by the banking organization. The disclosure requirements contained within the asset management exemption also serve to prevent potential investors from assuming a sponsored covered fund is guaranteed by its sponsor. Additionally, in certain foreign jurisdictions, regulators often encourage or mandate that the name of the sponsor or the adviser be included in the name of the fund in order to avoid investor confusion.

In the aggregate, members have had to change the name of thousands of entities, which comes with substantial compliance costs as well as loss of brand association, putting bank-affiliated advisers at a competitive disadvantage relative to non-bank affiliated competitors. Changing the names of these entities not only requires regulatory filings and the issuance of disclosures to investors but potentially could require approval from local regulators. Legislative proposals to revise the name-sharing prohibition have already been introduced in Congress—while a full elimination of the name-sharing restriction may require a change to the Volcker Rule statute, the current restrictions could be significantly relaxed through rulemaking or interpretive guidance.[65]

The restriction on covered funds sharing a name with a banking entity or its affiliates should be revised to only apply to the top tier holding company and any insured depository institutions within the banking organization.

G. Super 23A

1. *Align the application of the "Super 23A" prohibition with Section 23A and Regulation W by incorporating relevant exemptions into Super 23A*

We believe that the Agencies have construed the "Super 23A" statutory prohibition on a banking entity's transactions with a related covered fund more narrowly than the statute requires.

Under the statutory Super 23A provision, a banking entity is prohibited from entering into a transaction with certain related hedge funds and private equity funds (and their subsidiary covered funds) if the transaction "would be a covered transaction, as defined in section 23A of the Federal Reserve Act". In the Final Rule, the Agencies construed the phrase "covered transaction, as defined in section 23A of the Federal Reserve Act" to mean only those transactions specifically listed in Section 23A(b)(7) of the act, without regard to the exemptions for certain transactions from the restrictions of Section 23A set forth in Section 23A(d) of the act, or the complementary exemptions set forth in Section 223.42(d) of the Federal Reserve's Regulation W.[66]

The Agencies should interpret the scope of this statutory provision to be limited to "covered transaction[s]" subject to the exemptions set forth under Section 23A(d) of the Federal Reserve Act and Section 223.42 of the Federal Reserve's Regulation W, and they would be well within the scope

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65 We note that a bill to amend this statutory restriction was passed by the House on April 26, 2016 with strong bipartisan support (by a vote of 395-3). The Investor Clarity and Bank Parity Act, H.R. 4096, 114th Cong. § 2 (2016), is too limited in approach, however, because it would continue to prohibit the use of a name shared with an affiliated bank or BHC. The Investor Clarity and Bank Parity Act (H.R. 3093) was reintroduced for consideration by the 115th Congress in identical form on June 28th, 2017 and has been referred to the House Financial Services for consideration.

66 12 U.S.C. § 371c(d); 12 C.F.R. § 223.42.

Of particular note, Section 23A(d) of the Federal Reserve Act excludes from the restrictions of that act, *inter alia*, making a loan or extension of credit to, or issuing a guarantee, acceptance or letter of credit on behalf of, an affiliate that is fully secured by (A) obligations of the United States or its agencies; (B) obligations fully guaranteed by the United States or its agencies as to principal and interest; or (C) a segregated, earmarked deposit account with the member bank. 12 U.S.C. § 371c(d)(4). Similarly, the Federal Reserve's Regulation W provides exemptions from virtually all of the restrictions under Regulation W for, *inter alia*: (I) transactions secured by cash or U.S. government securities; and (II) certain intraday extensions of credit. 12 C.F.R. § 223.42(c), (l). Because of the associated requirements for reliance on the exemptions in Regulation W, such exemptions are designed to limit the risk of the banking entity being able to "stand behind" a related covered fund.

of their interpretive authority under long-established case law[67] to do so. In this respect, we also note that the statute specifically states that covered transactions under Super 23A should be analyzed "as if" the banking entity were a member bank and the fund were an affiliate thereof,[68] which evidences an intent to import the entire regulatory scheme applicable to transactions between a member bank and its affiliates, including the exemptions in Section 23A and Regulation W.

Interpreting the scope of Super 23A consistently with Regulation W would allow banking entities to continue providing certain services to related covered funds, consistent with standard market practice and without requiring funds to give up what are often longstanding relationships with their prime brokerage and custody providers. The prime brokerage exemption, which is available only for second-tier funds controlled by a banking entities' related covered funds (and not the related covered funds themselves), is too narrow to compensate for the failure to include traditional Section 23A/Regulation W exemptions in the Final Rule and does not preserve traditional prime brokerage and custody relationships between banking entities and their related funds. To date, only one of our members has indicated that they rely on the prime brokerage exemption, which required the implementation of a cross-divisional compliance framework with additional controls and reporting requirements, as well as the annual attestation for institutions that rely on the prime brokerage exemption.

In short, to the extent that Section 23A and Regulation W exempt certain otherwise "covered transactions" from the restrictions of Section 23A/Regulation W, we believe that those

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67 See generally Chevron U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837, 843-844 (1984) ("An initial agency interpretation [of a statutory provision] is not instantly carved in stone. On the contrary, the agency, to engage in informed rulemaking, must consider varying interpretations and the wisdom of its policy on a continuing basis."); Green v. Bock Laundry Machine Co., 490 U.S. 504, 528 (1989) (Scalia, J., concurring in the judgment) (meaning of terms of a statute should be determined "on the basis of which meaning is . . . most compatible with the surrounding body of law into which the provision must be integrated."); Deal v. United States, 508 U.S. 129, 132 (1993) (Scalia, J.) (it is a "fundamental principle of statutory construction . . . that the meaning of a word cannot be determined in isolation, but must be drawn from the context in which it is used."); United States v. Shimer, 367 U.S. 374, 367 (1961) ("We have long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer, and the principle of deference to administrative interpretations . . . has been consistently followed by this Court whenever decision as to the meaning or reach of a statute has involved reconciling conflicting policies. . . . If this choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, we should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned."); Inv. Co. Inst. v. CFTC, 720 F.3d 370, 376 (D.C. Cir. 2013) ("An agency changing course "need not demonstrate to a court's satisfaction that the reasons for the new policy are better than the reasons for the old one; it suffices that the new policy is permissible under the statute, that there are good reasons for it, and that the agency believes it to be better." (citing FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009)). . . . [T]he APA imposes no heightened obligation on agencies to explain "why the original reasons for adopting the displaced rule or policy are no longer dispositive." Id.") (upholding a CFTC rule expanding the scope of a 2003 rule).

68 12 U.S.C. § 1851(f)(1) ("No banking entity . . . may enter into a transaction with the fund . . . that would be a covered transaction, as defined in section 371c of this title, with the hedge fund or private equity fund, as if such banking entity and the affiliate thereof were a member bank and the hedge fund or private equity fund were an affiliate thereof.") (emphasis added).

transactions should not be deemed to be prohibited "covered transactions" for purposes of Super 23A.

2. *Clarify that the Super 23A prohibition does not apply extraterritorially to transactions by an international bank, or its affiliate, acting outside of the United States*

As implemented in the Final Rule, the Super 23A prohibition could be understood to prohibit all extensions of credit and other covered transactions by an international bank with all of its advised or sponsored covered funds, inside or outside of the United States. This result could not have been intended, and we believe that any such attempt to apply Super 23A in this manner would represent an unjustifiable extraterritorial expansion of the Volcker Rule's intended scope, as well as a departure from traditional bank regulatory principles. A lack of clarity about the extraterritorial reach of Super 23A has resulted in members building out a compliance program outside the United States where previously not required under Section 23A and Regulation W. This includes conducting diligence to determine whether a given client or entity is a covered fund for purposes of the Final Rule, even where the transaction is between a non-U.S. fund and a non-U.S. banking entity.

Implementation of Super 23A prohibition should, consistent with the policy objectives of the Volcker Rule, focus on the activities of banking entities inside the United States and not apply to the activities of international banks acting outside of the United States. For these reasons, **the Agencies should clarify that the Super 23A prohibition does not reach transactions by an international bank, or its affiliate, acting outside of the United States**, so long as the risk associated with the covered transaction remains outside the United States. Principles of statutory interpretation, traditional deference to home country bank regulation in this area and policy considerations each support this conclusion:

- First, the Agencies' interpretations of Super 23A should take into account the presumption against extraterritorial application of U.S. law.[69] Congress must clearly and affirmatively express an intent to apply U.S. law abroad, and it did not do so in the context of the Super 23A prohibition. Nothing in the statutory text of the Volcker Rule suggests that relationships between an international bank and non-U.S. funds (which international banks are expressly permitted to invest in, sponsor and advise), should be limited by Super 23A.

- Second, Congress and the Agencies have historically and consistently adhered to the principle of deference to home country regulation for the non-U.S. operations of international banks with respect to the regulation of credit extensions and other "covered transactions," which are traditionally matters subject to home country risk management standards and requirements. For instance, neither Section 23A itself, nor U.S. lending limits, apply to an international bank's non-U.S. branches.[70]

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69 The Supreme Court reaffirmed this principle in Morrison v. National Australia Bank, 130 S. Ct. 2869 (2010).

70 See, e.g., 12 C.F.R. § 223.61 (limiting the application of FRA Sections 23A and 23B with respect to international banks to transactions between their U.S. branches and agencies and certain affiliates).

Just as the Agencies had the authority to clarify in the Final Rule that Super 23A was not intended to prohibit investments in covered funds sponsored pursuant to Section ___.11 of the Final Rule, they should also clarify that Congress did not intend to limit lending or other covered transactions by an international bank outside of the United States.

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We appreciate your consideration of our comments on the Request for Public Input and our suggestions for the improvement of a proposed compliance and reporting framework for international banks. If we can answer any questions or provide any further information, please contact the undersigned (646-213-1147, smiller@iib.org) or our General Counsel, Richard Coffman (646-213-1149, rcoffman@iib.org).

Very truly yours,

Sarah A. Miller
Chief Executive Officer