ISDA® Safe, Efficient Markets

February 13, 2012

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Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
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Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

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

Re: Notice of Proposed Rulemaking: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (OCC RIN 1557-AD44; OCC Docket ID OCC–2011–14; FRB RIN 7100 AD 82; FRB Docket No. R-1432; FDIC RIN 3064–AD85; SEC RIN 3235–AL07; SEC File No. S7–41–11)

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to comment on the notice of proposed rulemaking ("**NPR**")[1] promulgated by the Office of the Comptroller of the Currency ("**OCC**"), Board of Governors of the Federal Reserve System ("**Board**"), Federal Deposit Insurance Corporation ("**FDIC**"), and Securities and Exchange Commission ("**SEC**") (collectively, the "**Agencies**"[2]), setting forth proposed regulations (the "**Proposed Rule**") to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**"), which established a new

[1] 76 Fed. Reg. 68846 (Nov. 7, 2011).

[2] The Commodity Futures Trading Commission ("**CFTC**") has refrained from joining in the Proposed Rule and has released its own version in the form of mark-up and commentary on the Proposed Rule: http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_28_VolckerRule/index.htm. We urge the Agencies to enlist the CFTC in a completely united rulemaking effort. Markets require coordination among regulators on regulations that cover identical issues.

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section 13 of the Bank Holding Company Act ("**BHCA**").[3] BHCA § 13, commonly referred to as the "Volcker Rule," contains certain prohibitions and restrictions on the ability of a banking entity or nonbank financial company supervised by the Board to engage in proprietary trading or have certain interests in, or relationships with, a hedge fund or private equity fund.

ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

Our comments below focus on issues related to the impact of the Proposed Rule's proprietary trading prohibitions on the "Swap" [4] activities of ISDA member firms. Although the Agencies have made efforts to implement the statutory requirements of BHCA § 13 in a thoughtful manner, ISDA believes that the Proposed Rule goes beyond what is required by BHCA § 13 and will have significant and unwarranted adverse effects on Swap markets, end-users and the Swap dealers themselves. We respectfully urge the Agencies to give further consideration to the basic approach of the Proposed Rule, as it pertains to Swaps in particular.

I. Introduction

The Agencies, like the Financial Stability Oversight Council ("**FSOC**"),[5] recognize that implementation of BHCA § 13 should not interfere with the effective delivery by banking entities of important client-oriented financial services, including market-making in derivatives.[6] The Agencies, again like FSOC, recognize the challenge in managing implementation of BHCA § 13 to avoid destructive effects on the provision of needed financial services.[7] Despite this recognition, however, the Proposed Rule would be highly detrimental to Swap customer business for the following principal reasons:

- The Proposed Rule would impose difficult restrictions on Swap dealer portfolio management. These restrictions will drive up costs, resulting in higher prices or the

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3 12 U.S.C. § 1851 ("**BHCA § 13**").

4 The Proposed Rule applies to derivatives broadly defined. *See* NPR at 68944. We do not agree that this definition should be as broad as the Agencies propose. See paragraph III. B.(1) below. Most of our comments focus on those instruments that would be "swaps," "securities-based swaps" or "mixed swaps" under an appropriate reading of Title VII of Dodd-Frank. We refer to those three classes of transactions as "Swaps", unless the context requires otherwise. (This usage is subject, of course, to our remaining concerns regarding the ultimate content of the Title VII definitions. See paragraph III. B.(1) below). Certain over-the-counter securities options and forward transactions engaged in by many ISDA members are not treated as swaps or security-based swaps under Title VII of Dodd-Frank, but are securities under Federal securities law. We do not comment in general on the treatment of securities under the Proposed Rule. It is important that we remind the Agencies, however, that our basic view of the Proposed Rule and the need for our recommendations is the same for banking entities transacting in these over-the-counter options and forwards as it is for those who deal in Swaps.

5 *See* FSOC, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships With Hedge Funds & Private Equity Funds* at 1, 5 (January 2011), hereinafter the *FSOC Study*.

6 NPR at 68849.

7 *Id.*

unavailability of product to customers, and reduced competition as Swap dealers leave the markets.

- The Proposed Rule would isolate the US Swap market from the global market and decrease US market capacity, competitiveness and liquidity, to the detriment of US customers and all banking entities (US or non-US based) that would try to continue to serve them.

- The Proposed Rule fails to "clearly describe the key characteristics of both prohibited and permitted activities."[8] In relying on (a) debatable presumptions, (b) a lengthy preamble (the "**Preamble**") containing many unanswered questions, including additional discussion in appendices, and (c) metrics to be elaborated upon and discussed in the examination process, the Proposed Rule does not meet the fundamental fair notice goal of regulation.[9] Although a metrics-based approach may be the only way to establish standards and assess compliance with such an inherently confusing rule, compliance and enforcement will inevitably be labor intensive, costly and confused. The degree of exposition and elaboration required suggest that the Agencies are not ready to propose a rule.

- The Proposed Rule mistakenly treats certain securitization vehicles as "covered funds" and separates these vehicles from sponsoring, advising or organizing banking entities that are providers of swaps needed to effect securitizations.

To diminish these substantial problems, ISDA respectfully suggests the following:

➢ <u>Revise the Proposed Rule to remove the presumption that all Swap dealing is proprietary trading and to broaden the Proposed Rule to genuinely support market making-related activities as the statute requires</u>. Rather than requiring Swap dealers to demonstrate that their Swap dealing activities do not constitute prohibited proprietary trading, the Agencies should determine that the common transactional activities of Swap dealing – including profit-taking – are permitted as "in connection with market-making", as the plain language of BHCA §13 demands, so long as these activities are bounded by appropriate internal policies and risk limits.[10] Consistently, the statute's reference to "market-making-related activities" should be construed to embrace common and prudently-managed trading activities of Swap dealers in support of their customer service businesses, as further described in section II below.

➢ <u>Revise the definition of "covered fund" to permit securitization and similar vehicles to have access to sponsoring, advising or organizing banking entities as Swap providers</u>.

➢ <u>Prepare detailed cost-benefit/economic analyses</u>. The Agencies should develop for public comment detailed analyses of the possible impact of the Proposed Rule on all affected parties, including most importantly end users and other consumers of

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[8] *Contra* NPR at 68849.

[9] *See Mason v. Florida Bar*, 208 F.3d 952, 958-59 (11th Cir. 2000) (dealing with bar rule).

[10] To be developed by Swap dealers in conjunction with their regulators.

financial products, as well as of the broader impacts on competition, markets and employment. In particular, these analyses should address whether Swap dealers subject to the Proposed Rule will be forced to substantially increase customer prices and fees to compensate for the revenue loss that will follow from eliminating efficiencies in portfolio management practice, should it be labeled prohibited proprietary trading. These analyses should be updated to reflect any changes as the draft rule progresses.

- Reconfigure the effectiveness/compliance aspect of the Proposed Rule so that effectiveness would first require banking entities to propose draft plans for their Swap dealing business (*i.e.*, policies, procedures and limits).[11] Only after consultation with and approval by the relevant Agencies should a banking entity be expected to implement its plans and begin to phase-in compliance over a suitable period agreed by each banking entity with its relevant Agencies.

- Prepare for public comment a revised proposed rule to be joined in by the CFTC. Given the serious issues raised by the Proposed Rule, a revised proposal should be issued by the Agencies for public comment, taking into account comments on the Proposed Rule and the detailed cost-benefit/economic analyses described above. In addition, to ensure uniformity of approach, and in compliance with statute,[12] the CFTC, which has issued its own version of the Proposed Rule,[13] should instead participate fully in the next proposal.

The Proposed Rule forbids banking entities from "proprietary trading." Proprietary trading, simply described in pertinent part for purposes of this comment letter, is defined as engaging as principal for the "trading account"[14] in any transaction to purchase or sell a derivative. A small number of exemptions exist from the proprietary trading ban. The three of most relevance to Swap trading activity are exemptions respectively related to market-making, trading on behalf of customers and hedging.[15]

Virtually every aspect of the definition of proprietary trading is subject to further definition and discussion in the Proposed Rule and Preamble. Both the market-making exemption and the hedging exemption are also subject to lengthy elaboration. Although we will discuss aspects of this elaboration below, we begin our comments by setting forth two important principles that we think should motivate the Agencies to revise the way the Proposed Rule will affect Swaps. We then review elements within the definition of proprietary trading, facets of the three exemptions mentioned above and aspects of ancillary matters – conflicts of interest,

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11 And, of course, other businesses similarly situated.

12 *See* BHCA § 13(b)(2)(B).

13 Very significant points, like the CFTC's declaration that it may diverge from the Agencies on the definition of market-maker, *see* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds at 95, RIN: 3038-AC, may be lost in the CFTC's proposal which takes the form of a mark-up of the Preamble and Proposed Rule. See: http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_28_VolckerRule/index.htm

14 Trading account, discussed below, is an artificial concept defined in section _.3(b)(2) of the Proposed Rule.

15 This is not to say that Swaps might not be embedded within activities, such as underwriting, that may be within other exemptions. To the extent that Swaps are used to facilitate exempt activities, they should be viewed as within the exemption applicable to that activity, whether or not the Swaps are independently exempt.

effective date and the concept of "trading unit." We conclude with a discussion of securitization and related fund-linked aspects of the Proposed Rule.

II. Major Principles

ISDA sees substantial problems with how the Agencies propose to implement BHCA § 13 with respect to Swaps. Of these problems, two are of paramount conceptual significance. One is the mistaken presumption that Swap dealing is proprietary trading." The second is the Agencies' misunderstanding of the nature of Swap intermediation business, in other words, Swap "market-making." The Agencies mischaracterize market-making as solely making two-way markets for customers. Swap market-making is a more complex activity that includes a necessary trading component that must be protected.

To appropriately resolve these two conceptual problems, we must divorce the word "trading" from the pejorative connotation cast by the Proposed Rule. Trading is the dynamic process of managing a Swap intermediation business as a responsive participant in the Swap markets. Trading optimizes an intermediation business's ability to offer customers excellent pricing: it is comprised of intermediation itself, hedging, maintaining "inventory" and positioning to capture efficiencies (through arbitrage or otherwise) that the market presents in the course of executing these varied functions. All of these functions are interrelated and each must be allowed to operate flexibly. Appropriately designed risk limits and policies should be more than sufficient to distinguish a healthy intermediation business from a potentially dangerous "prop shop."

We respectfully urge the Agencies to begin their reconsideration of the Proposed Rule with respect to Swaps with consideration of these fundamental issues.

A. Swap Dealing for the Trading Account – An Inappropriate Presumption

The Agencies should not presume that Swap dealer transactional activities constitute proprietary trading.

The Proposed Rule would treat as "trading accounts" any accounts used by a Swap dealer to take a covered position in connection with its Swap dealing business. This treatment would make all such covered positions prohibited proprietary trades unless an exemption can be identified. Neither BHCA § 13 nor the FSOC Study support this regulatory presumption. In fact, both focus on short-term trading as the proper object of regulation, not market-making or other dealer "accounts."[16]

The Preamble maintains that all dealer positions are based on short-term sales intent, because they are held for resale.[17] This assertion, however, is contradicted in the case of Swaps by many statements in the FSOC Study and the Preamble itself to the effect that Swap positions are often long-term, perhaps illiquid, and hedged by a variety of means, including short-term dynamic hedging, that may support the longer duration of the transactions.[18] The proposed

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[16] BHCA § 13(h)(g) (definition of trading account); *see also* FSOC Study at 1.
[17] NPR at 68860.
[18] *See, e.g.*, FSOC Study at 18, 20 and 29; NPR at 68875.

"Swap dealing equals trading account" aspect of the Proposed Rule is not only factually unsupportable, it is inconsistent with the FSOC recognition of the need for "critical intermediation in the financial markets that is to be protected from overly-zealous Volcker Rule enforcement."[19] As discussed below, we believe the proper approach is to begin the inquiry with the assumptions that common Swap dealer transactional activities are either intermediation or needed in support of intermediation, and not proprietary trading under any aspect of the Proposed Rule's definition of a trading account. We support the requirement that Swap dealing, as a customer service business, be subject to policies and metric limits prohibiting bright-line proprietary trading and otherwise meeting the objectives of BHCA § 13. We object strongly, however, to a presumption that at the outset delegitimizes Swap businesses of banking entities.

B. Permitted Business – Market-Making or Dealing?

The market-making-related activities exemption should be interpreted to implement faithfully the language of BHCA § 13 and permit trading "in connection with . . . market-making-related activities." In the Swap market, this will protect and preserve the critical intermediation business of Swap dealing.

The Proposed Rule, like BHCA § 13, offers an exemption for "market making-related activities."[20] This exemption on its face is broadly stated to extend to transactions "in connection with . . . market making-related activities." We comment in succeeding sections below on other elements of the proposed market-making exemption, as well as the allied exemption for hedging. Before reaching those discrete points, however, we must highlight an important clarification: In the Swaps market, the "critical intermediation" business to be protected and preserved within the "market-making" exemption is "Swap dealing" itself.[21]

Both the FSOC Study and the Proposed Rule take as their model of market-making the narrow model of market-making that may exist in some parts of the securities industry.[22] There are freestanding businesses in the equity securities industry that are simply market-makers in this narrow sense.[23] There are not such businesses in the Swap markets. Swap dealing is the Swap market analog to securities market-making. Market-making in the narrow sense is certainly the activity at the core of Swap dealing, but this core activity is not viable by itself as Swap intermediation. In other words, the basic Swap intermediation business model is Swap dealing, of which market-making is a vital ingredient. Swap dealing requires assuming risk from customers and managing that risk through a complex combination of customer and interdealer trading activity, all of which must be carried out in a prudent and economically rational manner.

We strongly believe that the full scope of Swap dealing is within the market-making exemption from BHCA § 13. Even if one accepts the Agencies' narrow view of market-making (and the statute does not dictate that view), the BHCA § 13 market-making exemption

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[19] *See* FSOC Study at 5.

[20] BHCA § 13(d)(1)(B); Proposed Rule, § __.4(b) and App. B.

[21] *See* FSOC Study at 5, *supra* note 14.

[22] See NPR at 68870 n. 147 (referring to "specialists") and accompanying text.

[23] It is beyond our purview to comment on whether or not these narrow market-making businesses should limit the concept of securities market-making generally.

sweepingly protects transactions "in connection with" market-making "related activities." The broad statutory language surrounding the phrase "market-making" indicates that it is the overall intermediation function that is to be protected, including market-making and its allied activities. Again, in the Swap markets, this totality is Swap dealing.

The Swaps intermediary business of banks evolved long ago from simple matched book market-making[24] into sophisticated portfolio-managed businesses. These businesses are able to offer services to customers at a satisfactory price because they are able to enter into Swap transactions expertly and flexibly in changing markets. Swap dealers can offer a cost basis acceptable to customers in part because a certain amount of trading, long- and short-term (and which is not, strictly speaking, hedging or "inventory"-building), is now part of Swap dealing – optimizing portfolio management and realizing efficiencies from constant attention to the market. As observed above, in the words of BHCA § 13, this trading is "in connection with market-making-related activities." Limiting trading so as to avoid dangerous aggregations of risk is sensible and should be readily accomplished with appropriate policies and risk metric assessments developed by banking entities with the approval of their regulators. Absolutely eliminating trading relating to these market-making activities will fundamentally change the structure and economics of Swaps intermediation. We question whether such a fundamental change to the Swap intermediary model will satisfy customer needs or permit Swaps intermediation businesses to survive.

In view of the breadth of the statutory language, we will refer long-form to the "market making-related activities" exemption in our subsequent references in this letter. We do so to underscore the true scope that is explicitly a part of the exemption, and that is necessary to protect the Swap intermediation function.

In the remainder of this letter, we both elaborate on the foregoing major principles and we address specific questions raised in the Preamble.[25]

III. Elements of Proprietary Trading

A. Definition of "Trading Account" (Question 14 et seq.)

(1) Variation Margin (Question 19)

The taking of variation margin is not an indicator of proprietary trading.

As noted above, the Proposed Rule includes in the trading account any position taken principally for the purpose of benefiting from actual or expected short-term price movements.[26] The Agencies state in the Preamble that this provision should be interpreted to include "a derivative, commodity future, or other position that, regardless of the term of that position,

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[24] We recognize that a small number of banks provide a hedging service to customers as part of their banking relationship. These banks operate on a "matched book" basis, obtaining their hedges not from other customer transactions, but from "full service dealers," without whom they could not operate.

[25] Appended to this letter is an index cross-referencing specific questions from the Preamble to our comments.

[26] Proposed Rule, § __.3(b)(2)(i)(A)(*1*).

is subject to the exchange of short-term variation margin through which the banking entity intends to benefit from short-term price movements."[27]

We assume the important risk-reducing aspect of taking variation margin is well-known to the Agencies. We have canvassed our members who uniformly have been unable to imagine real examples of the negative practices the Proposed Rule is intended to capture. The taking and return of variation margin is always capable of producing a short-term benefit, particularly when commodities subject to price volatility underlie the derivative or future contract. If variation margin in Swaps is seen generally as a proxy for prohibited proprietary trading, Swap dealers and financial end users of derivatives subject to BHCA § 13 will be disinclined to enter into transactions with variation margin. In light of applicable regulatory requirements relating to both cleared and uncleared Swaps,[28] the avoidance of variation margin in transactions would be neither desirable nor feasible. Finally, the Agencies' interpretive language appears to ignore the statutory requirement that a position be taken "principally" to benefit from short-term price movements in order to be included in the trading account.

We believe the Agencies should delete the concept of the taking of variation margin as an indicator of prohibited proprietary trading. At a minimum, the Agencies should (i) adopt language clarifying that adherence to applicable margin rules is a complete defense to any allegation that a position was taken "principally" for the purpose of benefitting from short-term price movements and (ii) stipulate that variation margin may be an indicator of proprietary trading only if the primary intent of the banking entity in taking variation margin is to benefit from short-term price movements.

(2) Market Risk Capital Rule (Questions 15, 28)

Reference to the Market Risk Capital Rule does not add meaning to the Proposed Rule. In any event, the influence of the Market Risk Capital Rule must be limited in this context.

The second prong of the proposed trading account definition provides that the trading account includes any account used to take covered financial positions that are "covered positions" for purposes of the Market Risk Capital Rule applicable to US banking organizations.[29] However, because all foreign exchange and commodity positions are considered "covered positions" under the Market Risk Capital Rules (regardless of whether they involve the short-term trading intent), an exclusion is provided for foreign exchange derivatives, commodity derivatives and contracts of sale of a commodity for future delivery.

ISDA does not see that this "add on" reference to the Market Risk Capital Rule adds dimension to the Proposed Rule. The Proposed Rule contains ample freestanding criteria that should operate independently of the Market Risk Capital Rule. Nonetheless, ISDA supports the Agencies' decision to exclude from the Proposed Rule's definition of the trading account positions that do not involve the short-term trading intent that is required by statute, regardless of

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27 NPR at 68858.

28 *See, e.g.*, *Notice of Proposed Rulemaking: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23732 (April 28, 2011).

29 Proposed Rule, § __.3(b)(2)(i)(B).

whether they may be within the Market Risk Capital Rule. We urge the agencies to establish this as a matter of principle going forward, as the Market Risk Capital Rule is presently subject to amending proposals. The fact that certain positions within the Market Risk Capital Rule need to be excluded, as described above, highlights that an appropriate articulation of the Proposed Rule should not need to be bolstered by the Market Risk Capital Rule.

For the same reason, with respect to Question 28, ISDA also does not believe that it would be appropriate or consistent with the language or spirit of BHCA § 13 for the Agencies to use their discretionary authority to include within the definition of "trading account" any account used to take "certain [unspecified] [30] long-term positions" that do not involve short-term intent to trade or otherwise benefit.

(3) Overbreadth as to Swap Dealers (Question 22)

As discussed in detail in section II.A above, we believe the Proposed Rule is mistaken in presuming that Swap dealing activities generally constitute short-term trading.

B. <u>Definition of "Covered Financial Position" (Question 46 et seq.)</u>

The proprietary trading restrictions of BHCA § 13 extend only to "covered financial positions." Consistent with the relevant statutory language, the Proposed Rule generally defines "covered financial position" to include any security (including any option on a security), any derivative (including an option on a derivative) and any contract of sale of a commodity for future delivery (or option thereon).[31] We focus below on the Swap aspects of this definition.

(1) Definition of "Derivative" – in General (Question 54)

The Agencies should defer judgment on whether, and to what extent, the definitions adopted by the CFTC and SEC in the Title VII context should be adopted for purposes of BHCA § 13.

The Agencies propose to define "derivative" to include, among other items, any "swap" or "security-based swap" as defined under the Commodity Exchange Act and Securities Exchange Act, respectively, and as further defined by the CFTC and SEC by joint regulation or interpretation pursuant to Title VII of Dodd-Frank.[32] The definition of derivative would exclude (i) agreements, contracts or transactions that the CFTC and the SEC define as not within the definition of "swap" or "security-based swap," and (ii) certain identified banking products.[33]

The CFTC and SEC have issued a joint proposed rule and proposed interpretations (the "**Further Definition Release**") to further define "swap," "security-based swap" and other key terms under Title VII.[34] The Further Definition Release includes a number of controversial

[30] In fact, we have been unable to ascertain what real positions, if any, the Agencies are referencing.
[31] Proposed Rule, § __.3(b)(3).
[32] Proposed Rule, § __.2(l)(i).
[33] Proposed Rule, § __.2(l)(ii).
[34] 75 Fed. Reg. 80174 (Dec. 21, 2010).

elements that have received substantial industry comment.[35] In light of the different policy goals underlying BHCA § 13, on the one hand, and the establishment of a comprehensive new regulatory framework for swaps, on the other, ISDA believes that the Agencies should defer judgment on whether, and to what extent, the definitions adopted by the CFTC and SEC in the Title VII context should be adopted for purposes of BHCA § 13. A determination on this question should not be made until the results of the joint CFTC and SEC effort are known and can be carefully reviewed and analyzed specifically with respect to their impact under BHCA § 13. As a general matter, however, ISDA believes that products determined specifically not to warrant regulation as swaps under other applicable law (in particular, Title VII of Dodd-Frank) should not be recast as swaps under BHCA § 13.

(2) Physically-Settled Commodity Forwards (Question 56)

Contracts eligible for the forward contract exclusions from CFTC and SEC jurisdiction should be excluded from the proprietary trading ban under BHCA § 13.

The Agencies propose to define "derivative" to include forward contracts in nonfinancial commodities intended to be physically-settled,[36] notwithstanding that such contracts are excluded by statute from both CFTC and SEC regulation (and the Dodd-Frank definition of "swap"[37]) in order to avoid diminishing their availability and utility. ISDA believes that contracts of the sort eligible for the forward contract exclusions from CFTC and SEC jurisdiction should likewise be excluded from the proprietary trading ban under BHCA § 13, so as to avoid new constraints on the availability of these contracts.

(3) Foreign Exchange Forwards and Swaps (Question 55)

Physically settled foreign exchange Swaps and forwards should be excluded from the proprietary trading ban under BHCA § 13.

The Agencies also propose to include within the definition of "derivative" physically settled foreign exchange Swaps and forwards,[38] which the Treasury Department has proposed to exempt from the definition of "Swap" under Title VII of Dodd-Frank.[39] The Treasury Department's proposal to exempt these items notes specifically that features such as fixed and predetermined payment obligations "make foreign exchange Swaps and forwards more similar to funding instruments, such as repurchase agreements, which are not covered under the [Commodity Exchange Act ("**CEA**")]."[40] Purchases and sales of covered financial positions in connection with repo transactions are likewise exempt from BHCA § 13's proprietary trading restrictions. Moreover, foreign exchange Swaps and forwards have been adequately regulated as traditional bank products for many years. As Treasury has recognized, the risk profile of these products differs substantially from other derivatives and is adequately managed under existing

35 ISDA's comment letter on the Further Definition Release, which highlights a number of key issues yet to be resolved with respect to these key definitions, is incorporated herein by reference. The comment letter is available at www.sec.gov/comments/s7-39-10/s73910-55.pdf.

36 Proposed Rule, § __.2(l)(i)(B).

37 7 U.S.C. § 1a (47)(B)(ii).

38 Proposed Rule, § __.2(l)(i)(C).

39 *See* 76 Fed. Reg. 25774 (May 5, 2011).

40 *Id.* at 25776.

market mechanisms. Disrupting the liquidity and safety of existing markets would be contrary to the stated policy goals of BHCA § 13. Accordingly, ISDA respectfully requests that the Agencies exclude these products from the definition of derivative for purposes of BHCA § 13.

C. Definition of "Purchase" and "Sale" (Question 13)

The definitions of "purchase" and "sale" should be revised to relate only to actual changes in ownership of a Swap.

The terms "buy," "purchase," "sale" and "sell" are defined in the Proposed Rule, with respect to a derivative, to include the "execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations … ."[41] This definition is overbroad because it fails to distinguish between (i) true purchases and sales–*i.e.*, where ownership changes occur or obligations are first established and (ii) subsequent performance, avoidance, or modifications of contractual rights (for example, option exercise, amendment or negotiated price change). ISDA believes that the former, but not the latter, may be considered trading activity. Accordingly, we respectfully request that the Agencies revise the definitions of purchase and sale to better track changes in ownership. Acts that may constitute purchases or sales that are driven by counterparty rights or requirements should be outside the scope of any analysis of the banking entity's trading intent.

IV. Exemptions

The general prohibition under BHCA § 13 against banking entities engaging in proprietary trading activities is subject to several exemptions. We comment below on the exemptions related to market-making, trading on behalf of customers and hedging.

A. Market Making-Related Activities Exemption (Question 80 et seq.)

In addition to the points regarding market-making stated above in section II above, the following important concerns also require attention:

(1) Illiquid Swap Markets; Distinct Exemptive Criteria (Questions 88-94)

The market making-related activities exemption set forth in the Proposed Rule seems to contemplate, in the first instance, market-making activities in highly liquid markets such as equities.[42] The text of the Proposed Rule is then supplemented by sporadic discussion in the Preamble regarding how the exemption should be interpreted and applied with respect to market-making in less liquid or illiquid markets.[43] In ISDA's view, a better approach would be to construct a coherent, dedicated rule subpart that explicitly preserves all market making-related

41 Proposed Rule, §__.2(g), (v).

42 In response to Question 88, ISDA believes this reliance on the Exchange Act model to be inappropriate.

43 Salient differences between derivatives market-making and securities market-making include: (a) lack of a formalized derivatives market structure imposing per se market-making responsibilities (*see* NPR at 68871, n.148 and n.151); (b) lack of product simplicity and homogeneity (*see* NPR at 68870); (c) in particular, wide variability in transaction duration; (d) relative lack of liquidity (*see* FSOC Study at 29); and (e) dealing as obligor on the instrument that is the transaction, rather than as transferor from "inventory" of the obligation of a third party (*see* NPR at 68869, n.142).

activities and focuses principally on markets (like the Swap market) generally lacking the liquidity and other features of the exchange-traded equities market.[44]

The continuous/regular discussion establishes an important principle: Swap market illiquidity should be reflected consistently throughout the Proposed Rule.

For example, the Proposed Rule would require that the trading unit or other organizational unit relying on the market making-related activities exemption hold itself out as willing to buy or sell or to enter into positions on a "regular or continuous" basis.[45] ISDA believes, and the Preamble indicates that the Agencies agree, that the term "continuous," which is drawn from the SEC's securities-oriented definition of "market maker," should be removed in the Swap context. A Swap market maker has no fixed responsibilities to trade and may not offer a price at a given moment due to a variety of factors unrelated to speculation. "Regular" by itself constitutes a sufficient limitation to achieve the statutory purpose of limiting the exemption to *bona fide* market-making activities.

Although the Agencies recognize that "continuous" is not a requirement of market-making in illiquid markets,[46] they fail to give full and appropriate weight to the reasoning underlying this conclusion. For example, the Preamble provides no general relief for the Swaps market-maker from the requirement to provide "widely accessible and broadly disseminated quotes."[47] Such relief would seem a needed corollary to the Footnote 149 statement that "[t]he frequency of … regular quotations will itself vary; less illiquid markets may involve quotations on a daily or more frequent basis, while highly illiquid markets may trade only by appointment."[48] The Preamble also states that indicia of market-making related activities in OTC markets "should generally include … holding oneself out as willing and available to provide liquidity by providing quotes on a regular (*but not necessarily continuous*) basis (emphasis added).[49] We think "but not necessarily continuous" should be removed from this statement, as part of a broader effort to recognize the relative illiquidity of Swap markets and to consistently adjust exemptive criteria accordingly. Agency recognition of Swap market illiquidity should extend in unified fashion to the treatment of Swaps under the Proposed Rule.[50]

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[44] We assume that the reference in the Proposed Rule to certain registered market makers (*see* NPR at 68891, Question 179) is to parties with trading responsibilities parallel to those placed on market makers in the equity securities markets. Accordingly, the proposed restriction would not apply or relate to participants in Swaps facilities. If, however, that were not the case, we would be concerned that the proposed requirement would constrict liquidity in our low liquidity markets.

[45] Proposed Rule, § __.4(b)(2)(ii).

[46] *See* NPR at 68871.

[47] *Id.*

[48] *Id.*

[49] *Id. n. 149*

[50] Proper treatment of illiquidity, of course, must be based on well-wrought definitions of transaction types and markets. There must be careful consideration as well of the degree of presence a market-maker wishes to have in a given market. In other words, a market-marker may wish to be a leader in one or more types of swaps, a secondary presence in other types and in the process of entering or leaving other submarkets. These considerations are particularly appropriate to a policies-based, consultative approach to regulation.

Reasonable anticipatory Swap positioning under the market making-related activities exemption should be permitted, in recognition of the effect of Swap market illiquidity.

ISDA supports the Agencies' recognition that *bona fide* market-making must be interpreted to include (i) block positioning undertaken for the purpose of intermediating customer demand and (ii) taking positions in securities in anticipation of customer demand.[51] However, with respect to the latter, the Agencies discussion could be misconstrued to apply to positions "in securities" only. The Agencies should clarify that anticipatory positioning is permitted with respect to any covered financial position and not just positions "in securities." In addition, the extent to which such activities would be permitted—*i.e.*, " ... so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties"[52]—should be further clarified. Illiquid and low-volume markets necessitate that Swap dealers take a longer and broader view than dealers in liquid markets.[53] In other words, what is reasonable in an illiquid market may be vastly different from what is reasonable in liquid markets.

The requirement of the Proposed Rule that market making-related activities be designed to not exceed the reasonably expected near term demands of customers, clients or counterparties[54] raises a number of questions in the context of market-making in Swaps. First, ISDA believes that the market making-related activities exemption should be clarified as encompassing a variety of ancillary activities related to and supporting a dealer's anticipation or response to counterparty demand (see paragraph II.B. above). Second, as noted above, anticipatory positioning to meet customer demand is an indispensable component of a Swap dealer's market-making activities and may involve some consistency in trading activity in the dealer market (particularly as market conditions change over time) not directly linked to a specific expectation of customer demand for particular transactions. The Agencies should clarify that such ancillary activities, subject to reasonable policies and limits crafted in light of the purposes of BHCA § 13, will be recognized as being undertaken "in connection with" legitimate market making-related activities.

(2) Regulated Dealer Status (Question 95)

The requirements that (i) a US banking entity be a CFTC or SEC registered swap dealer and (ii) a non-US based entity engaged outside the United States in the Swap dealing business be subject to "substantive regulation" in order to rely on the market making related-activities exemption for Swaps should be eliminated.

To use the market making related-activities exemption for swaps, one must be a CFTC or SEC registered swap dealer or security-based swap dealer, as appropriate (or exempt from such registration), or engaged in the swap dealing business outside of the United States and subject to "substantive regulation" of such business in the jurisdiction in which such business is

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51 NPR at 68871.

52 *Id.*

53 Similarly, any requirement that a block position must be liquidated as rapidly as possible, *see* NPR at 68872, n.151, would be misplaced.

54 Proposed Rule, § __.4(b)(2)(iii).

undertaken.[55] This is unnecessary and raises difficult questions that should be extraneous to what a banking entity, regulated as such, may do. On the US side, this requirement would have banking regulators redundantly enforcing the registration requirements of the CFTC and the SEC. The CFTC and SEC, furthermore, have not yet completed their regulations ultimately defining their respective dealer categories. These definitions in proposed form, particularly the CFTC's "point of connection" definition of swap dealer, do not focus on the market-making core of the swap dealing business.[56] In other words, CFTC "swap-dealing" and the Agencies' "market-making" may be different things. As a threshold matter, ISDA believes that fundamentally inconsistent regulations put in tandem operation can only confuse the regulated community. Effective regulation requires that key requirements be adopted with reasonable uniformity by the responsible regulators.

US imposition of the requirement of substantive regulation of a dealing business outside the United States raises a host of difficult questions, ranging from the propriety of a US review of the adequacy of non-US regulation to determining which non-US regulation is sufficiently "substantive." ISDA believes it is inappropriate for the Agencies to begin an analysis of what is "substantive" regulation outside the United States and, in particular, we note that the standard should not be one of comparability to US regulation.

(3) Dealer "Investment" Positions (Question 350)

Activities requiring swap dealer registration should be presumed to be within the broad "market making-related activities" exemption.

The Agencies ask in Question 350 whether Swap dealers (i) hold accounts other than trading accounts or (ii) hold investment positions for activities for which they are required to be registered, and, if so, whether including all such dealer positions within the trading account definition would create competitive issues or burdens on the operations of the dealers that may not be consistent with the language and purpose of the statute. We have observed that the breadth of dealer activities may challenge the assumed limitations of such accounts. For example, products that are complex to hedge, like "spark spreads" and "crack spreads" in the commodity Swap markets, may produce investment-like positioning in support of dealer activity. Such positioning should be exempt from the prohibitions of the Proposed Rule. In general, positions held for activities requiring swap dealer registration should be presumed to be within the broad "market making-related activities" exemption discussed above.

(4) Arbitrage Transactions (Question 91)

Arbitrage transactions engaged in by market makers that promote liquidity or price transparency should be permissible under the market making-related activities exemption.

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55 Proposed Rule, § __.4(b)(2)(iv)(B)

56 This inconsistency could yield banking entities required to register as dealers, but unable to use the market making-related activities exemption from BHCA § 13 because they do not make two-way markets. Please see ISDA's discussion of the CFTC's novel definition of dealing at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27904&SearchText=young.

Although some arbitrage transactions might be considered prohibited proprietary trading, the Agencies observe that there are certain arbitrage activities engaged in by market makers that promote liquidity or price transparency but do not serve customer, client or counterparty demands.[57] ISDA believes that such activities should be permissible, though we note in addition that (i) these activities often do yield transactions and positions that are ultimately put to use in serving customer demand, (ii) the very process of consistently transacting makes the dealer ready and available to serve customers on a competitive basis and (iii), in some Swap markets, dealers hedge through multiple instruments, giving an impression of arbitrage in a function that is risk reducing. For example, dealers in broad index equity Swaps may simultaneously hedge in baskets of stock, futures, ETFs, *etc*.

(5) "Client," "Customer" and "Counterparty" (Question 99)

The terms "client," "customer" and "counterparty" do not require further definition in the market-making-related activities exemption context.

The Agencies have not defined the terms "client," "customer" and "counterparty" for purposes of the market making-related activities exemption and have solicited comment on whether those terms should be defined in this specific context. ISDA believes these terms are sufficiently clear in this context that further definition is not required and could create additional and unnecessary complexity in the exemption. If the Agencies do elect to define these terms, ISDA believes it is important that the definitions retain the full breadth of the exemption provided by statute. In particular, in defining "counterparty," the Agencies should be careful to retain its plain meaning–*i.e.*, one who is on the other side of a transaction from the market maker—and not conflate the term with "client" or "customer," which could be read to imply, in erroneous limitation, some relationship beyond the isolated provision of a transaction. Indeed, other dealers are appropriate counterparties. Finally, in ISDA's ultimate view, distinctions among the three terms are irrelevant given their use in the disjunctive in this portion of the Proposed Rule.[58]

B. Permitted Trading on Behalf of Customers (Question 131)

The exemption for trading on behalf of customers should be clarified to encompass all the potential variants on trading for or on behalf of customers (or acting in support of customer trades) that now exist or are anticipated as the cleared Swap market develops.

The Agencies propose to interpret the statutory exemption for trading in covered financial positions on behalf of customers as permitting three general categories of transactions: (i) trading activity conducted in the context of customer-driven investment or commodity advisory, trust, or fiduciary services, provided that the customer (and not the banking entity) benefits from any gains and suffers from any losses on such covered financial positions; (ii) trading as riskless principal; and (iii) trading for the separate account of insurance policyholders by insurance companies.[59] ISDA believes that the proposed exemption for trading on behalf of customers

[57] NPR at 68873, Question 91.

[58] In other words, the broadest term, counterparty, should prevail. To avoid confusion, we urge the Agencies to clarify the Proposed Rule Appendices to conform to this principle.

[59] Proposed Rule, § __.6(b).

should be clarified to clearly encompass all the potential variants on trading for or on behalf of customers (or acting in support of customer trades) that now exist or are anticipated as the cleared Swap market develops. For example, we would assume that unmentioned functionaries like futures commission merchants and introducing brokers, under appropriate circumstances, would be viewed as within the exemption.

C. Additional Market-Supporting Roles of Swap Market-Makers and Other Banking Entities (Questions 125, 130-31).

The proposed rule should be modified to provide that market-makers and other banking entities can participate in industry-wide market-support mechanisms without fear of rule violations.

The Swap markets have evolved mechanisms that require market-maker support beyond the market-maker's core dedication to offering two-way prices. Clearing and the credit derivatives auction process, both explained below, are two examples of these mechanisms. Banking entities are involved in both. The Proposed Rule should offer clear accommodation for these mechanisms, and similar mechanisms that may develop in the future.

Cleared Swaps

Dodd-Frank contains an imperative to clear Swaps. As a result, banking entities have joined or will join clearinghouses as clearing members. Banking entities who become clearing members will have special transactional duties upon the default of a fellow clearing member to support the clearinghouse by participating in an auction of the defaulting clearing member's portfolio and stepping into transactions previously belonging to the defaulted member or its customers.[60] Clearinghouse members may also have duties to engage in transactions that assist in price verification and transparency. Banking entities who are futures commission merchants ("FCMs") will have special transactional duties upon the default of a customer (each FCM as guarantor of its customers' positions being obliged to perform on those positions). Each of these activities must be clearly permitted under the Proposed Rule. The Proposed Rule must acknowledge that banking entities, without Volcker liability, may fully honor their commitments within the cleared Swap regulatory regime and clearinghouse rule and practice, whether the clearinghouse is within the US or elsewhere.[61]

Credit Derivatives Auctions

Credit derivatives auctions were organized by ISDA at the urging of regulators[62] to provide liquidity and uniformity to credit default Swap settlements. The auction framework

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60 *See* Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissioners, *Principles for Financial Market Infrastructures* at 64, n.86 and accompanying text, March 2011.

61 Our comments above relate specifically to the "agency" clearing model dominant in the U.S. To the extent that a Swap dealer clears trades under a principal clearing model, as exists in other jurisdictions, it suffers perhaps greater risk under the Proposed Rule by intermediating the cleared trade - standing between customer and clearing house. Both clearing models should be free of the prohibitions of the Proposed Rule.

62 *See, e.g.*, letter of July 30, 2008 from multiple banks and trade associations to T. Geithner, President, Federal Reserve Bank of New York.

relies on the support of Swap dealers and other banking entities. Upon the happening of a credit event (triggering potential settlements) and the decision that an auction is appropriate, Swap dealers and other banking entities are looked upon to provide bids and offers used to determine market pricing. To validate these bids and offers, and provide liquidity for market participants entitled to physically settle their transactions, these Swap dealers must be ready to satisfy physical settlements at the auction price (essentially buying or selling obligations (frequently bonds)). Participating Swap dealers and other banking entities also gain settlement rights in the auction process. To avoid destabilizing the auction process, we urge the Agencies to modify the Proposed Rule to make clear that a banking entity that settles within an ISDA credit derivatives auction or participates in such an auction will not be engaging in proprietary trading.

Swap clearing and the credit derivatives auction are but two examples of market-support mechanisms in which Swap market-makers and other banking entities *must* participate for the good of the market and the preservation of their businesses. Other mechanisms are likely to become similarly recognized as the Swap markets continue to develop. The Proposed Rule should contain a generic safe-harbor for participation in such mechanisms.

D. Hedging Exemption (Question 102 et seq.)[63]

(1) Unnecessary Restrictions (Questions 102-105, 108-110)

The hedging exemption should apply to any trade designed to reduce a specific risk, regardless of whether it meets any formal definition of "hedge." Further, the utility of the hedging exemption should not be compromised by the attachment of inappropriate and unworkable conditions.

ISDA agrees that the hedging exemption to the proprietary trading ban should include trading that hedges "or otherwise mitigates" risk (emphasis added).[64] We ask the Agencies to confirm that a position designed to reduce a specific risk in connection with a Swap is eligible for this exemption, whether or not it meets any formal definition of "hedge."[65] ISDA applauds the proposal that a hedge transaction may relate to individual or aggregate positions or holdings of a banking entity and that "dynamic hedging" and "portfolio hedging" are within the scope of the exemption.

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[63] The Proposed Rule offers a hedging provision within the market-making exception (__.4(b)(3)) and a general hedging exemption (__.5(a)). Our comments should be understood to apply to both.

[64] Proposed Rule, § __.5(b)(2)(ii). We believe a determination of the risk mitigation characteristics of a position can be made only with a view to facts and circumstances at the time the position is created, taking into account among other things, portfolio position and the relevant entity's overall hedging and risk-mitigating strategies.

[65] *See* NPR at 68874. Even if not as narrowly defined as it may be, for example, for accounting purposes (*see*, *e.g.*, Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging), hedging can be viewed narrowly as a means of reducing earnings volatility. Thus if a person has an exposure of + 100 and sells -80 futures, that person's net position is +20 and that person can be said to have placed a hedge. Mitigation, by contrast, is broader. If, instead of selling the futures, a person buys an out of the money put option, that put option might have a small delta (perhaps only -40, giving a net of 60) and may not be an "economically appropriate" hedge for ordinary market movements. However, if the underlying drops 50 percent, the put would mitigate the person's far downside. Banking entities should have the freedom to act on the anticipated cost/benefits of such mitigation strategies, whether on an individual transaction or portfolio basis.

ISDA also welcomes the Agencies' inclusion of anticipatory hedging within the exemption. However, the Agencies would drastically diminish the utility of this exemption by requiring that the anticipatory hedge not anticipate more than "slightly" the relevant specific risk and "not involve the potential for speculative profit."[66] Again, ISDA would remind the Agencies that some revenue enhancement achieved through book management is a vital component in maintaining acceptable prices to customers. Appropriate policies, limits and examination metrics should be sufficient to assure that the hedging process does not hide impermissible proprietary trading. Requiring an imponderable parsing of trade timing and the active avoidance of incidental profit is unnecessary and impractical.[67] Although the Agencies recognize that a portfolio presents multiple overlays of risk to manage, the Proposed Rule requires that a hedging transaction not give rise to "significant exposures that are not themselves hedged in a contemporaneous transaction."[68] This limitation threatens the viability of the hedging exemption. Hedge costs figure importantly in calculating the bid/offer for Swaps. A portfolio manager may justifiably wish to trade one risk for another, even knowing that the latter risk may be significant and may need to be borne until an opportune moment to hedge it arises. Again, appropriate policies, limits and examination processes are appropriate curbs on potential excesses.

In general, we respectfully urge the Agencies to adopt a presumption that risk mitigating activities are not subject to the prohibition on proprietary trading. Appropriate safeguards in terms of policies and procedures and metrics should be adequate to avoid abuse of the exemption.

(2) Fund-linked Swaps (Questions 281-83, 287)

The hedging exemption in the covered fund portion of the Proposed Rule is too restrictive. The same hedging exemption that applies generally to the proprietary trading restriction (see paragraph above) should apply to fund-linked Swaps activities as well.

Fund-linked Swaps (Swaps linked to interests in various types of pooled investment vehicles) comprise a special (and important) segment of the Swap markets. It is common practice for dealers of fund-linked derivatives to implement their hedges through Swaps and/or investment in ownership interests in covered funds referenced in their fund-linked Swaps. The hedging exemption in the covered fund portion of the Proposed Rule, however, is needlessly more restrictive than the general hedging exemption discussed in the paragraphs above. (It could be read to allow hedging only for reverse inquiry delta-one transactions.) Dealers in fund-linked Swaps may not be able to portfolio hedge or dynamically hedge due to the constraints of Proposed Rule §___.13(b)(2)(ii)(B). The need for flexibility in hedging techniques is as important to fund-linked Swaps as to other Swaps. We urge the Agencies to include the hedging of fund-linked derivatives within the generally applicable hedging exemption under the Proposed Rule and to eliminate additional requirements that will interfere with effective management of fund-linked risk.

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66 NPR at 68875.

67 *See* NPR at 68875 (describing as proprietary trading a transaction yielding "appreciably more profits on the hedge position than it stood to lose on the related position").

68 Proposed Rule, § __.5(b)(2)(iv); *see also* NPR at 68875-76.

V. <u>Ancillary Matters</u>

A. Conflicts of Interest (Question 190 et seq.)

The conflicts of interest rule should be clarified to recognize that market makers often have conflicts of interest with customers beyond merely being on the opposite sides of a transaction and having differing economic interests.

The Proposed Rule would prohibit otherwise permitted proprietary trading activities that would involve or result in a material conflict of interest between the covered banking entity and its clients, customers or counterparties.[69] "Material conflict of interest" would be defined as a transaction or other activity that would involve or result in the covered banking entity's interest being "materially adverse" to the interests of its client, customer or counterparty with respect to the transaction unless (i) prior to a specific transaction, the banking entity makes effective and timely disclosure of the conflict so that the client may understand the conflict and have an opportunity to mitigate the adverse effect of the conflict or (ii) the banking entity has established information barriers reasonably designed to prevent the conflict of interest from resulting in a materially adverse effect on the client (except that a banking entity cannot rely on such barriers if it should reasonably know that in the case of a specific transaction the conflict will result in a materially adverse effect on a client).[70]

In ISDA's view, the conflicts of interest rule should be further clarified in recognition of the fact that market makers often have conflicts of interest with customers beyond merely being on the opposite sides of a transaction and having differing economic interests. For example, a covered banking entity making markets in credit default Swaps referencing a particular entity may also have a lending relationship with the entity. The Agencies should clarify that this type of conflict may be addressed with generalized disclosure, including in trading relationship documentation (*e.g.*, "we may offer lending and other services to issuers on which we write credit default Swaps"), rather than identifying particular service relationship types or clients (and potentially breaching confidentiality obligations). In any event, this conflict, and others inherent in the business, should be treatable with form disclosure provided once in advance of all trades to which the disclosure relates rather than transaction-by-transaction. The latter is impractical[71] and offers little or no meaningful protection in the Swap context where a market maker's counterparty is likely to be a sophisticated institutional investor with experience with industry standard disclosures and contractual provisions.

Information barriers which prevent informational advantage should be sufficient under the Proposed Rule.

In addition, ISDA believes the Agencies should clarify that any information barriers required in order to satisfy the requirements of the Proposed Rule are those which prevent informational advantage (as long recognized by the SEC), rather than preventing any and all

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[69] Proposed Rule, § __.8(a).

[70] Proposed Rule, § __.8(b).

[71] Transaction-by-transaction disclosure would slow transactions and create the risk of unintended breach of confidentiality duties to others.

material adverse effects on a client.[72] Information barriers, standing alone, do not cure or prevent conflicts, but rather protect counterparties by ensuring that the traders of a covered banking entity do not act on the basis of material nonpublic information unavailable to the counterparties. Thus, ISDA recommends that the Agencies state that, where applicable, the following elements (derived from prior guidance from the SEC and securities self-regulatory organizations) may be used to establish the reasonableness of information barriers designed to prevent informational advantages that would have materially adverse effects on clients:

- Memorialization of information barrier procedures (and documentation of actions taken under the procedures);

- Creating watch/restricted lists (*i.e.*, lists of covered financial positions subject to restrictions because a banking entity is in possession of material, nonpublic information with respect to such positions);

- Limiting availability of material, nonpublic information regarding covered financial positions to those employees who, for example, have a "need to know" through the following means:

    - physically separating departments with sales or trading functions from departments that regularly receive confidential information;

    - supervising interdepartmental communications (*e.g.*, establishing so-called "wall-crossing" procedures); and

- Creating effective education and training programs for covered employees (*i.e.*, those employees likely to come into possession of material, nonpublic information regarding covered financial positions).

B. <u>Effective Date (Questions 1-4)</u>

The Proposed Rule should not be implemented with respect to Swaps until after final regulations under Title VII have been adopted.

The statutory effective date of BHCA § 13 is July 21, 2012, and the Agencies have proposed that banking entities implement the compliance requirements of the Proposed Rule by the effective date.[73] The Agencies state further in the Preamble that banking entities should conform their activities to the requirements of the Proposed Rule "as soon as practicable" after the effective date.[74]

Swap dealers and major swap participants continue to face an uncertain implementation period for the new regulatory requirements under Title VII of Dodd-Frank. ISDA strongly believes that the proprietary trading compliance schedule and, in particular, the restrictions on

[72] Use of information barriers must of course be limited to contexts where needed and effective. Such barriers are costly to maintain and interfere with many benign activities.

[73] *See* NPR at 68855.

[74] *Id.*

proprietary trading in Swaps, should not be implemented until after final regulations under Title VII have been adopted. Among other problems, substantial uncertainties would arise in the market if the Proposed Rule's prohibition on proprietary trading in Swaps (and the market-making exemption thereto) were to take effect before the definition of "swap dealer" is finalized for purposes of Title VII. The definition of "swap dealer" is important in determining whether the third prong of the Proposed Rule's definition of "trading account" even applies – and thus, whether and to what extent a banking entity is subject to the proprietary trading ban.[75]

Additionally, ISDA recommends that the Agencies adopt a clearly defined extended implementation period, reflective of the fact that the Proposed Rule's compliance procedures will be evolutionary and should not be finalized by a banking entity without regulatory agency assessment of the banking entity's policies and practices. While the Agencies address this point in a general matter in various instances in the Preamble, ISDA believes that principles of fairness and the universal goal of avoiding undue market disruption each argue in favor of further elaboration on this point.

C. <u>Trading Units/ Enforcement (Questions 157-159)</u>

The metrics set forth in Appendix A should be further developed and clarified with respect to how they will apply given idiosyncrasies of banking entity organization.

Appendix A offers an extensive array of diverse metrics to be applied to trading activities.[76] "Trading unit" is the defined term establishing the organizational structures within a banking entity that may be subject to reporting of metrics. Because this definition attempts to capture individually the smallest "discrete" units involved in trading activities, it breeds confusion as to the use of the metrics themselves. A missing principle vital to gathering metric information is how these measures will apply given idiosyncrasies of banking entity organization. For example, how will these metrics apply to a bank with a centralized Swap trading desk that serves multiple business groups of varying type, as well as the bank's own treasury? Obviously, principles must be developed to treat situations like this in an orderly, predictable manner.

Our comments on Appendix A provide an example of an overall problem with the complexity of both the language of the Proposed Rule and the metrics intended to analyze compliance or not. This complexity will be effectively "squared" in its application to complex banking businesses. ISDA questions whether and how cost-effective compliance can be obtained, with the degree of certainty that responsible businesses will wish to achieve on behalf of their shareholders and customers.

VI. <u>**Swaps with Funds**</u> (Questions 217-18, 225, 227)

Section 13(f) of the Volcker Rule proscribes certain relationships (including Swaps in some cases) between banking entities and hedge funds or private equity funds. The Proposed Rule follows section ___13(h) in defining "covered fund" to include any securities issuer that

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[75] This observation is subject of course to our reservations, articulated above, concerning the use of swap dealer status in this context.

[76] *See* NPR at 68956-60.

would be an investment company under the Investment Company Act of 1940, but for the Section 3(c)(1) or 3(c)(7) exemption from the '40 Act. Section 13(h) and the Proposed rule also treat commodity pools, as defined in section 1a(10) of Commodity Exchange Act, as covered funds.

Several issues of overbreadth attach to the definition of covered fund. First, many securitization vehicles are exempt from the '40 Act under sections 3(c)(1) and 3(c)(7). These securitization vehicles are (a) not within common concepts of hedge fund or private equity funds, (b) important financing and financial risk transfer mechanisms that Congress intended to protect, not hamper[77] and (c) highly dependent on Swaps as hedges or as "assets" facilitating synthetic securitization. [78]

Reciprocally, securitization vehicles constitute important, liquidity-providing Swap market participants. The unwarranted severing of the Swap market from securitizations by barring the sponsors, advisers or organizers that would be most likely to provide Swaps would decrease transaction diversity and volume, and raise prices.

Second, the definition of commodity pool is tremendously broad if not tempered by relevant exemptions. We urge the Agencies to review exemptions under the Commodity Exchange Act and, by analogy, exemptions under the Investment Company Act, and design exemptions appropriate to apply to the commodity pool definition in the context of the Proposed Rule.

Last, and more generally, we question whether the prohibitions attaching to covered funds should apply to banking entity relations with covered funds whose business is a business that a banking entity could enter into directly. To stand a familiar adage appropriately on its head, why should a bank be barred from doing indirectly what it can do directly?

We understand the Agencies' dilemma in implementing the statute. At the same time, we believe that the Agencies should not be content to gloss over critical distinctions among issuers that are highly relevant to the purposes of the Volcker Rule. For example, securitization vehicles largely serve to transfer risks held by originators (frequently banks) to others. Hedge funds and private equity funds are actively managed, acquirers of risk, but they typically do not originate it. Unlike securitization vehicles, they are not free standing balance sheets -- purpose built to accept the risk transferred by an originator or sponsor. We believe that securitization vehicles should be able to engage in Swaps to the same extent as any other counterparty, and not be burdened by the restrictions attaching to dealings with covered funds under the Proposed Rule. Similarly, we believe that only those commodity pools that function as hedge funds should be within the ambit of the Proposed Rule, and that banking entities should not be restricted in their dealing with "funds" that simply do business that the banks themselves are permitted to do.

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77 *See* FSOC Study at 1, 7.

78 The Volcker Rule's section 13(g)(2) expressly protects securitization of loans. Unless one accepts as controlling the often disregarded maxim of construction that "the expression of the one is the exclusion of the other" (*see Barnhart v. Peabody Coal*, 537 U.S. 149, 168 (2003)), this express protection does not mean that the Agencies are without the ability to fashion the Proposed Rule to accommodate securitization generally.

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ISDA appreciates the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Sincerely,

Robert Pickel
Chief Executive Officer

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