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RIN: 3064-AD85

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Docket No. R-1432
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Securities and Exchange Commission
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Release No. 34-65545; File No. S7-41-11
RIN: 3235-AL07

Attention: Comments

Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

Barclays Capital[1] appreciates the opportunity to submit these comments on the regulations that the above-listed U.S. financial regulatory agencies (the "Agencies") have proposed for the

[1] Barclays Capital is the investment banking division of Barclays Bank PLC. Barclays Capital provides large corporate, government, and institutional clients with a comprehensive set of solutions to their strategic advisory, financing, and risk management needs. Barclays Capital has offices around the world and employs over 25,000 people.

purpose of implementing Section 619 ("Section 619," commonly known as the "Volcker Rule") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2]

Barclays welcomes the efforts of Congress and the Agencies to enact effective oversight regulations to provide consumers, the markets, and banking institutions with a stable financial system. We appreciate the importance, as expressed in the Preamble, of defining parameters to effectuate the Volcker Rule while preserving the benefits of market making and other activities that meet client needs.

We recognize that regulatory oversight is important to the restoration of public trust that banking entities cannot do without. We support the notion of protecting government-backed deposits and ensuring that behavior by any single institution does not jeopardize the stability of the international financial system. Nevertheless, we submit that the Volcker Rule should not be implemented in such a way as to disrupt global financial markets. We believe our comments address issues facing many market participants who rely on banking entities to facilitate access to capital, including within the United States, where financial markets are the deepest and most efficient in the world.

Barclays endorses portions of the Preamble and the Proposed Rule in which the Agencies have interpreted important aspects of the Volcker Rule. For example, the Preamble appropriately provides that the government obligation exemption encompasses the purchase or sale of enumerated government obligations on a forward basis, including the to-be-announced ("TBA") market,[3] and the Agencies properly recognize the need to differentiate market making principles and the variability in trading patterns among different types of markets as described in Appendix B to the Proposed Rule.[4] We also support the Agencies' guidance in the Preamble regarding the permissibility of portfolio hedging, which allows banking entities to mitigate risk efficiently across trades and trading units.[5] We believe that the underwriting exemption, as set forth in the Proposed Rule, generally effectuates the aims of the statute while largely avoiding undue interference with established markets, although we note the importance of certain technical changes to the requirements for that exemption.[6]

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[2] The regulations that are the subject of these comments consist of Notice of Proposed Rulemaking (the "Preamble") and the accompanying proposed rule text (the "Proposed Rule") that would implement the Volcker Rule. For purposes of this letter, we refer to both the joint notice of proposed rulemaking, 76 *Fed. Reg.* 68846 (proposed Nov. 7, 2011), and the Commodity Futures Trading Commission's (the "CFTC") notice of proposed rulemaking as the "Proposed Rule," but we cite to pages of the Federal Register version of the joint notice of proposed rulemaking (the "NPR").

[3] *See* footnote 164 of the Preamble, NPR at 68878. We believe that this is a very important clarification in light of the TBA forward market for agency mortgage backed securities. By significantly improving liquidity in the market for agency mortgage backed securities, the TBA market helps to ensure tighter spreads for agency issuances, lowering mortgage rates and borrowing costs for consumers.

[4] *See* NPR at 68960.

[5] The Agencies recognize in the Preamble that Section 619(d)(1)(C) is intended to permit portfolio hedging: "Notably, and consistent with the statutory reference to mitigating risks of *individual or aggregated positions*, [Proposed Rule Section __.5(b)(2)(ii)] would include the hedging of risks on a portfolio basis." NPR at 68875.

[6] *See*, *e.g.*, the comments regarding the Proposed Rule's underwriting exemption made by the Securities Industry and Financial Markets Association ("SIFMA"), a trade association of which Barclays is a member, in its letter pertaining to the proprietary trading-related provisions of the Proposed Rule.

Nevertheless, as more particularly set forth in this letter, we are concerned that certain key aspects of the Proposed Rule are deficient and will lead to a significant negative impact on the efficient functioning of the U.S. and international financial systems, with a particularly disruptive effect on the capital markets. We respectfully submit that, as currently proposed, these aspects of the Proposed Rule will have significant unintended and negative consequences on U.S. and global economies, on U.S. job creation and retention, and on the liquidity, the cost and the availability of capital in the U.S. and global financial markets. We also expect related repercussions for many companies to which the Volcker Rule was not, by its terms, intended to apply (*i.e.*, entities which would not be covered by the term "banking entity"), but which nonetheless depend on such markets to fund their operations.

Our comments and alternative proposals focus on mitigating these negative consequences. We believe that our suggested modifications to the Proposed Rule, which are consistent with statutory parameters, better further the goals of the Agencies to carry out Congress' intent to safeguard affected banking entities and promote the financial stability of the United States.

In summary, our comments and alternative proposals include the following:

- We believe that the Proposed Rule represents an inappropriate one-size-fits-all approach to the market making and hedging exemptions that does not properly take into account the way market intermediaries operate, especially in less liquid markets. We propose a reformulation of these exemptions, including a presumption of compliance for so long as a trading activity is conducted in a manner consistent with tailored quantitative metrics.

- In light of the function that banking entities perform in the international markets for non-U.S. government obligations, the final rules should include an additional exemption for trading in such instruments.

- The exemption for trading in government obligations does not cover trading of exchange-traded futures or options on such instruments, failing to recognize the importance of trading in related exchange-traded futures and options to the underlying market in the cash instruments themselves. We recommend that the Agencies use their authority under Section 619(d)(1)(J) to include an exemption to permit trading in exchange-traded futures and options on (i) the obligations exempted by the statute and in Section __.6(a) of the Proposed Rule, and (ii) non-U.S. government obligations for which we also request an exemption.

- The proposed elements of the trading "solely outside of the United States" exemption are excessively restrictive, negate legislative intent, will have an inappropriate extraterritorial impact and will harm U.S. asset managers and other entities. As such, the exemption for trading solely outside of the United States (the "offshore trading exemption") should be modified in the final rules to omit the requirements that no party to the relevant transaction may be a resident of the United States and that the relevant transaction must be executed wholly outside of the United States.

- We believe that the intertwined provisions in the Proposed Rule regarding the definitions "banking entity" and "covered fund" and the so-called "Super 23A"

prohibitions should be modified to avoid presumably unintended far-reaching and adverse consequences. Among other changes, we recommend narrowing the definition of "covered fund" to more closely approximate the characteristics of a hedge fund or private equity fund, and carving out fund activities conducted solely outside of the United States (the "offshore funds exemption") from the application of Super 23A.

- We recommend that the Agencies provide for a "phase-in" approach to implementation of the Proposed Rule's reporting, recordkeeping and compliance program requirements over the conformance period.

- In order to avoid duplicative, unnecessary, and costly compliance and supervision burdens, we believe that there should be a single Agency that has responsibility for each enterprise with respect to administration (including supervision, examination, compliance, and enforcement) of the Volcker Rule, and that this should ideally be the primary umbrella Federal regulator of the enterprise.

Given the various deficiencies in the Proposed Rule as currently drafted and the importance of promulgating final rules that do not pose a threat to consumers, the financial markets, banking institutions, or the stability of the financial system, we respectfully request that the Agencies re-propose regulations to implement the Volcker Rule, incorporating the elements identified in this letter, and publish the re-proposal for further public comment.

I. Market Making-Related Activities

The Proposed Rule's Market Making Exemption

Congress properly understood the critical role that market making plays in the efficient and stable functioning of global financial markets, and accordingly included a broad exemption for market making-related activities in the Volcker Rule. Regrettably, we believe that the intent of Congress to preserve this traditional financial intermediation function is greatly undermined by the Proposed Rule. The Proposed Rule is unworkable outside of exchange-based, liquid markets and imposes an unwieldy and ill-advised compliance framework on banking entities that would need to rely on the market making exemption. We believe that the Proposed Rule would unjustifiably inhibit *bona fide* market making activities, which in turn would have a negative impact on efficiency of execution, transaction costs, timing delays, volatility, and liquidity across the U.S. and international financial system. This deterioration in overall market quality will, in turn, impact the prices of traded securities and new issuances, decreasing returns for investors and increasing the cost of capital for U.S. companies.[7]

As discussed in more detail below, we respectfully submit that in order to avoid these outcomes the market making-related activities exemption should be modified to provide:

- qualitative criteria that take into account the way in which different markets function; and

[7] This discussion is responsive to NPR Questions 80 and 81.

- a presumption of compliance so long as each trading unit's activities are consistent with a discrete set of five tailored metrics (compressed from the 17 separate metrics currently set forth in Appendix A to the Proposed Rule) and related specific thresholds, as coordinated and agreed with the relevant regulator.

This approach would address the Agencies' objective of preventing the use of the market making-related activities exemption to conduct prohibited proprietary trading, while preserving traditional market making activities, including in markets that require intermediaries to hold significant inventory ("highly intermediated markets").

Implications for Market Makers and Markets

The Proposed Rule's market making-related activities exemption requirements[8] appear to be founded almost entirely upon the paradigm of agency-based, highly liquid, exchange-traded markets, with a large number of continuous or near-continuous willing buyers and sellers of a limited range of products in small transactions.[9] In those markets, minimal capital outlay and minimal attendant principal risk taking by market makers may indeed be possible.

This is not how many financial markets function. In most fixed income and commodities markets, customer needs require that banking entities provide traditional market making services due to various factors, including the nature of the assets being traded and the intermittent and unpredictable demands of clients. In these markets, where there is little or no continuous natural demand from buyers and sellers to transact in any single instrument, a participant wanting to execute a trade must find an intermediary willing to position the risk as principal until the intermediary can find a natural offset for the trade. For this purpose, market makers transact in a broad range of financial instruments in order to create a more immediately available supply of and demand for financial instruments for the benefit of customers, even in illiquid or volatile market conditions and at volumes that other market participants are unable to provide.[10]

Additionally, we note that our concerns with the Proposed Rule's market making exemption may also apply in the context of certain equity markets in which, for example, one or more of the elements of the foundational paradigm described above are not present. While it is possible that, in the event the final rules are adopted in a form that decreases the ability of banking entities to provide liquidity to the markets, other entities may have sufficient available capacity to step in, it

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[8] The Proposed Rule requires that a purchase or sale of a covered financial position shall be deemed to be made in connection with a banking entity's market making-related activities only if: (i) a trading unit holds itself out as being willing to buy and sell on a regular or continuous basis, (ii) a trading unit's activities are, with respect to the covered financial position, designed not to exceed the reasonably expected near term demands of clients, customers or counterparties, and (iii) a trading unit's activities are designed to generate revenues primarily from income not attributable to price appreciation of covered financial positions. Proposed Rule Section __.4(b)(2)(ii) and (iii), Section __.4(b)(2)(v).

[9] We note that, in the Preamble, the Agencies recognize that the qualitative requirements in the Proposed Rule's market making exemption may not be applicable in all circumstances. NPR at 69970-1. However, we believe that this recognition would be of limited utility at best, particularly because it does not provide any guidance as to when and under what circumstances the qualitative requirements would not apply and because this recognition is not reflected in the Proposed Rule itself. We therefore believe that the revised approach that we propose is more appropriate.

[10] This discussion is responsive to NPR Questions 85 and 90.

is likely that any such activity will involve entities in the unregulated shadow banking sector. We believe that migration of pivotal market functions to this unregulated, less transparent sector would in and of itself be destabilizing for the financial system.

Several proposed elements of the market-making related activities criteria generally do not reflect the nuances of how market makers operate in principal trading markets. The proposed requirement that a market maker hold itself out as willing to buy and sell covered positions on a regular or continuous basis cannot be met in the markets for certain less liquid instruments or for certain asset classes. For example, in fixed income markets where prices are not frequently quoted for a large number of instruments and individual instruments are only rarely traded, it is not common for a market maker to hold itself out as willing to both buy and sell certain instruments on a regular or continuous basis. In markets of this kind, the requirement that the market maker hold itself out as being willing to buy and sell on a regular or continuous basis would needlessly prohibit traditional and essential market making functions. [11]

The Proposed Rule's bias against holding inventory is not an appropriate measure of whether a market maker's activities are "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties,"[12] and negates the statute's intent to preserve principal risk taking by market makers as a necessary component of intermediated markets.[13] To illustrate, a mutual fund may face redemption requests that would require it to sell a large bond position quickly, regardless of whether enough natural demand exists in the relevant market. The mutual fund will therefore sell the position to a market maker, who may need to keep the position in its inventory for hours, days or months, depending on the instrument's characteristics and market conditions. In addition, it is common practice for market makers in the commodities derivatives markets to accumulate positions over time in order to be ready to honor large trades that customers demand (often unpredictably), and for market makers to have long-term customer-facing exposures that may be difficult to hedge promptly. Even in liquid, exchange-traded markets, a market maker may acquire a large position from a customer in circumstances where it is not in the best interests of the market, the market maker, or the customer for the market maker to proceed to immediately sell the entire position.[14]

Moreover, the Proposed Rule's requirement that a market maker design its activities to generate revenues primarily from income not attributable to price appreciation is not sufficiently nuanced to take into account the realities of dynamic markets, in which prices frequently move based on factors beyond the control of a market maker. A particular instrument's market price may appreciate or depreciate while held in inventory, either with or without a countervailing

[11] This discussion is responsive to NPR Question 91.

[12] Section 619(d)(1)(B).

[13] Congress expressly permitted principal risk taking by dealers when it exempted "[t]he purchase, sale, acquisition or disposition of securities or other instruments…in connection with…market-making-related activities." Section 619(d)(1)(B). The legislative history of Section 619 makes clear that the Agencies must look to current market practice when setting forth standards to differentiate market making from proprietary trading: "[the market making exemption] would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function. Without that flexibility, market makers would not be able to provide liquidity to markets." Bayh-Dodd Colloquy, 156 *Cong. Rec*. S5906 (daily ed. July 15, 2010).

[14] This discussion is responsive to NPR Question 94.

movement in price of a corresponding hedge position. The ultimate sale of that instrument will necessarily be priced to reflect the change in the underlying market, in addition to any bid/ask spread. In fact, a bid/ask spread cannot be defined on a consistent basis with respect to many instruments. This does not indicate impermissible proprietary trading intent, but rather simply reflects the realities of movements of markets that do not function along the lines of the conceptual underpinnings of the Proposed Rule.[15]

Furthermore, the Proposed Rule would require the creation of unnecessarily complicated and burdensome compliance programs, including the requirement that certain banking entities with extensive market making operations calculate and report 17 quantitative metrics. Most of the 17 metrics set forth in Appendix A to the Proposed Rule are either redundant or impractical. In addition, the Proposed Rule's current formulation, including the references to evaluating whether a particular "purchase or sale" is deemed to be in connection with permissible market making-related activities and to examining compliance with respect to a particular "covered financial position," could be read to require subject banking entities to attempt to analyze these issues on a trade-by-trade basis, despite expressed regulatory intent.[16] This would not be possible to accomplish in an environment where hundreds or thousands of trades can occur in a single day in a single trading unit.[17]

We anticipate that the cumulative impact of the Proposed Rule's approach will include decreased liquidity, impaired price discovery, wider bid/ask spreads, slower execution, and increased volatility, as traditional market makers convert their platforms to agency or agency-like models to avoid breaching the qualitative requirements of the Proposed Rule. As a result, investors will reduce exposure to less liquid or more volatile markets in order to avoid the losses associated with selling directly to other investors at inopportune times. Mutual funds, pension funds, 401(k) funds and similar market participants will also require premiums to compensate for increased risk associated with diminished market quality. Individuals participating in mutual and other funds will suffer lower returns as the funds will be required to hold greater cash balances to accommodate possible redemptions in unfavorable market conditions. Moreover, without the ready presence of market makers, investors who, for a variety of reasons, may need to sell significant portions of illiquid portfolios from time to time, may be forced to incur heavier losses than they otherwise would have or may be unable to sell the relevant securities at all.[18]

Such effects would not be isolated to secondary markets. The price of new issuances will take into account the reduced liquidity in the secondary markets, increasing the cost of capital. Issuers, particularly smaller companies, may find themselves unable to issue debt at attractive yields, locking them out of the capital markets; the cost of refinancing also may become prohibitive, eventually resulting in higher default rates. The resulting decrease in the ability of

[15] This discussion is responsive to NPR Question 96.

[16] Mary Schapiro, Chairman of the Securities and Exchange Commission, and Gary Gensler, Chairman of the Commodity Futures Trading Commission, have testified that it is not their intent to evaluate compliance with the Volcker Rule on a trade-by-trade basis. In fact, Chairman Gensler testified that he favors a "policies and procedures" approach to compliance. *See* statements of Schapiro and Gensler at the Joint Hearing of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit on the Volcker Rule, January 18th, 2012.

[17] This discussion is responsive to NPR Question 321.

[18] This discussion is responsive to NPR Questions 83 and 351.

non-financial businesses to fund operations and investments would decrease levels of economic activity and job creation by U.S. corporations, both domestically and internationally.

Modifications to the Market Making Exemption's Requirements

We suggest the Agencies' approach to implementing the market making exemption should be modified to permit market makers to perform their traditional function on behalf of customers, taking into account the differences in markets and products.[19]

First, we believe that the qualitative criteria in Proposed Rule Section __.4(b) should be revised as follows (for ease of reference, the text below is marked to reflect our proposed changes):

- The ~~purchase and sale~~ market making-related activity is conducted by each trading unit such that it holds itself out as being willing to buy and sell on a regular or continuous basis to the extent that two-sided markets are typically made by market makers in a given product;

- The ~~purchase and sale~~ market making-related activity is conducted by each trading unit such that its activities (including maintenance of inventory) are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties consistent with the market and trading pattern of the relevant product, and consistent with the reasonable judgment of the banking entity where such demand cannot be determined with reasonable accuracy; and

- The ~~purchase and sale~~ market making-related activity is conducted by each trading unit such that its activities are reasonably designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income ~~not attributable to appreciation in the value of covered financial positions it holds or the hedging of covered financial positions it holds in trading accounts~~ attributable to satisfying reasonably expected customer demand.

The Proposed Rule should also explicitly confirm that a banking entity will be deemed to presumptively comply with the statutory and regulatory requirements of the market making exemption for so long as its trading units' activities are consistent with a discrete set of tailored metrics and related specific thresholds coordinated and agreed with the relevant regulator. We discuss these metrics and thresholds below, in our description of our proposed metrics-based compliance framework.[20]

II. Hedging Activities

The Proposed Rule's Hedging Exemption

In order to continue to provide customers with permitted financial intermediation services, such as underwriting and market making, a banking entity must have the ability to hedge associated risks effectively and cost-efficiently. We believe that the Proposed Rule's provisions regarding

[19] This discussion is responsive to NPR Question 87.

[20] This discussion is responsive to NPR Questions 146 and 148.

permissible hedging activities will inappropriately limit a banking entity's hedging activities and thereby increase risk to individual banking entities and to the U.S. and international financial system as a whole, contrary to statutory intent. The hedging-related provisions of the Proposed Rule are inconsistent with market realities, will invite *post hoc* trade-by-trade analysis, and will impose a compliance framework that is excessively burdensome and complex. To the extent that necessary and proper hedging of individual and portfolio risks is curtailed by the Proposed Rule, the Proposed Rule itself could prove a serious obstacle to the ability of banking entities to conduct their activities in a safe and sound manner. Further, banking entities will not engage in otherwise permitted customer-facing trading activities, which the Volcker Rule expressly seeks to preserve, if the Proposed Rule prevents effective and cost-efficient associated hedging.[21]

In order to avoid these unintended negative consequences, we respectfully submit that the hedging exemption, like the market making exemption, should be modified in line with the statutory text, focusing on:

- qualitative requirements that are consistent with existing risk-monitoring procedures and that will permit banking entities to continue to hedge their financial intermediation activities; and

- a presumption of compliance so long as hedging activities are consistent with applicable metrics and related specific thresholds, as coordinated and agreed with the relevant regulator.

We believe these modifications, which we describe in more detail below, would most closely give effect to the statutory mandate to permit risk-mitigating hedging activity, and would avoid the potential negative impact on banking entities' financial stability and on customers and markets in general.

Implications for Banking Entities and Markets

The Proposed Rule imposes a number of requirements[22] on a banking entity seeking to enter into a hedging transaction that would significantly undermine banking entities' *bona fide* hedging activities because they do not take sufficient account of conceptual and practical issues related thereto. We are also concerned that the requirements of the Proposed Rule concerning the hedging exemption, including the references to determining compliance with respect to "the purchase or sale," could result in regulatory review of individual hedging trades for compliance

[21] This discussion is responsive to NPR Questions 102 and 103.

[22] The Proposed Rule's hedging requirements include that each purchase or sale (i) hedges or otherwise mitigates one or more specific risks arising in connection with and related to individual or aggregated positions, (ii) is reasonably correlated to the risk or risks the transaction is intended to hedge or otherwise mitigate, and (iii) does not give rise, at the inception of the hedge, to significant new exposures that are not hedged contemporaneously. The Proposed Rule also requires that each such transaction be reviewed, monitored and managed on an ongoing basis to confirm (i) compliance with required hedging policies and procedures, (ii) maintenance of a reasonable level of correlation, and (iii) mitigation of any significant exposure arising out of the hedge after inception. Proposed Rule Section __.5(b)(2). Furthermore, if a hedging transaction or series of transactions by a banking entity is established at a level of organization different from the level of the organization responsible for establishing the underlying positions or risks, the banking entity is required to produce specified documentation at the time such hedging transactions are conducted. Proposed Rule Section __.5(c).

on a *post hoc* basis. As discussed above with respect to the market making exemption, without a presumption of compliance with the relevant provisions of the Volcker Rule for activities that conform to specific metrics thresholds, prudent regulatory risk management would effectively push banking entities to a trade-by-trade analysis at the inception of hedging trades as a practical matter out of concern for regulatory review, despite regulatory intent. In addition, the text of the Proposed Rule requires that each "purchase or sale" or "hedge" be subject to ongoing review, monitoring and management of individual transactions under Proposed Rule Section __.5(b)(2)(v), which appears to be inconsistent with the acknowledgement by the Agencies, in the Preamble, that Section 619(d)(1)(C) is intended to permit portfolio hedging. This is problematic because it would be impossible to tie each individual purchase or sale to a particular portfolio hedge. We submit that the necessity and benefits of efficient portfolio and dynamic hedging, together with the impracticable burden of imposing the ongoing monitoring and other evaluation requirements on a trade-by-trade basis, demonstrate the necessity of a presumptive compliance approach and the evaluation of ongoing risk exposures at the trading unit level (whether the unit is hedging in connection with its otherwise permissible trading activities, or the unit is engaged in other hedging activity for the banking entity, *e.g.*, hedging aggregate portfolio positions and risks).[23]

Moreover, the requirement that a given hedging transaction must hedge or otherwise mitigate one or more specific risks arising in connection with and related to individual or aggregate positions could also be read to render a banking entity's hedges impermissible if those hedges do not succeed in hedging or mitigating an identified risk as determined by a *post hoc* analysis. Banking entities enter into hedging transactions in anticipation that certain risks will arise (or increase), but such risks may not necessarily materialize, or the hedging transactions may not be fully effective in mitigating the underlying risk. A banking entity should not be penalized for seeking, in good faith and as a prudential matter, to reduce its risks, even if the hedging transactions are not ultimately necessary or effective.[24]

The requirement that a hedging transaction be reasonably correlated to the risk or risks that the transaction is intended to mitigate, and the related provision requiring that a transaction be reviewed, monitored, and managed on an ongoing basis to maintain a reasonable level of correlation also could be read to render a banking entity's hedges impermissible if they do not succeed in being reasonably correlated to the relevant risk or risks based on an after-the-fact analysis. We understand that the Agencies were seeking to prevent proprietary trading under the guise of hedging, and we appreciate and agree with the Agencies' position that the degree of correlation that is reasonable for any given hedge will vary depending on the underlying risks and the availability of alternative hedging options.[25] However, the current formulation in the Proposed Rule may create an unwarranted risk that banking entities seeking to properly conduct their hedging activities will be subject to censure if their assumptions and expectations regarding correlation prove to be incorrect with the benefit of hindsight.[26]

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[23] This discussion is responsive to NPR Questions 105 and 112.

[24] This discussion is responsive to NPR Question 108.

[25] NPR at 68875.

[26] This discussion is responsive to NPR Question 110.

Furthermore, the requirement of contemporaneous documentation for each hedging transaction or series of transactions conducted at a level of organization different from the level of the organization responsible for establishing the underlying positions or risks is unrealistic. Hedging transactions may be properly entered into not just at either a trading unit level or at an entity/enterprise-wide risk management level, but also on a rapid basis within division/organizational units for which management may pursue hedging activities across trading units, for certain asset classes or products, or for a particular type of customer-facing trading function (such as market making). Separate documentation of hedges should not be required for hedging activities conducted by a supervisor within the same division as the trading activity giving rise to the risk being hedged.[27]

Finally, the requirement that a hedging transaction not give rise, at its inception, to significant new exposures that are not contemporaneously hedged is inconsistent with the reality of hedging permissible trading operations in certain highly intermediated markets and asset classes. As discussed above with respect to market making, highly intermediated markets are characterized by low liquidity, which means that taking the exact opposite side of a trade is nearly always impossible. However, as a prudential matter, a banking entity may seek to reduce its overall risks by hedging with instruments in other asset classes. Such hedging serves to reduce risk, as measured by VaR and other relevant measurements, but it may introduce new risks to the banking entity. For example, it is fairly common to hedge customer-facing "long" positions in corporate bonds with credit default swaps because of an inability to borrow the identical corporate bonds at a cost-effective price. This hedging approach would reduce overall risk, but would introduce basis risk. A banking entity will seek to hedge that new exposure efficiently and cost effectively. However, that is not always possible and a banking entity should not be required to further hedge for so long as the relevant risk is within the risk limits attributable to the trading unit in question and to the banking entity's portfolio risk management policies more generally. Additionally, given that portfolio hedging may result (both at inception of a particular hedge and subsequently over time) in modification of hedging exposures across a variety of underlying risks, even as the overall risk profile of a banking entity is reduced, it would become impossible to subsequently review, monitor and manage individual hedging transactions for compliance with the elements of Proposed Rule Section __.5(b)(2)(v).[28]

We anticipate that the cumulative impact of the above-described deficiencies of the Proposed Rule as currently drafted will have a chilling effect on hedging activities because banking entities will logically reduce hedging efforts in order to mitigate potential regulatory risks and ensure regulatory compliance. Reduced hedging will, in turn, lead to some combination of increased economic risk for each banking entity (and increased systemic risk more generally) and decreased customer-facing financial intermediation activities by banking entities as they seek to ameliorate the risks posed by positions that they cannot practically hedge. This is entirely contrary to the aims of the Volcker Rule to reduce risk as a prudential matter and to preserve crucial customer-facing activities such as market making and underwriting.[29]

[27] This discussion is responsive to NPR Question 114.

[28] This discussion is responsive to NPR Question 111.

[29] This discussion is responsive to NPR Question 351.

Modifications to the Hedging Exemption's Requirements

In order to address the concerns described above, and permit banking entities to hedge in a manner that appropriately permits market making and underwriting related activities and that ensures banking entities can engage in hedging activities that ensure safety and soundness, we suggest the following modifications to the Agencies' approach to implementing the hedging exemption.[30]

First, the qualitative criteria in Proposed Rule Section __.5 should be revised to provide that hedging activities (whether of a given trading unit or of a higher level organizational unit, including the larger banking entity itself, in connection with hedging aggregate portfolio positions and risks) should be reasonably designed such that (for ease of reference, the text below is marked to reflect our proposed changes):

- The ~~purchase or sale~~ hedging activity was reasonably expected to hedge~~s~~ one or more specific risks that were expected to arise in connection with individual or aggregate positions;

- The ~~purchase or sale~~ hedging activity ~~is~~ was reasonably expected to be correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks that the ~~purchase or sale~~ activity ~~is~~ was intended to mitigate;

- The ~~purchase or sale~~ hedging activity ~~does not~~ has not given rise, at the inception of the hedging transactions, to significant exposures (that were not already present in the individual or aggregated positions, contracts, or other holdings of the covered banking entity) ~~and that are not hedged contemporaneously~~ that were not within applicable pre-established risk limits;

- The ~~purchase or sale~~ risk exposure of the relevant trading unit ~~is subject to continuing review, monitoring, and management that~~ remained.~~;~~ ~~(A)~~ ~~is~~ consistent with required written hedging policies and procedures (including risk limits)~~; (B) maintains a reasonable level of correlation with the risks; and (C) mitigates any significant exposure arising out of the hedge after inception~~; and

- With respect to risk-mitigating hedging activities ~~where such activities take place at a level of organization~~ conducted by either a trading unit (or other organizational unit) in a division different than, or by non-supervisory personnel in a unit within the same division as, ~~that is different from the level of organization~~ the unit establishing or responsible for the risk that the hedging activity is designed to reduce, ~~such level of organization~~ the unit engaging in the hedging activity will be required to, at a minimum, document (at the time the hedging activities are conducted): (i) the risk-mitigating purpose of the hedging transaction (or series of transactions), (ii) the risks of the individual or aggregate positions that the hedging transaction (or series of hedging transactions) ~~is~~ was reasonably designed to reduce, and (iii) the unit ~~level~~ of the organization engaging in the hedging activity.

[30] This discussion is responsive to NPR Question 107.

In addition to these modifications to the qualitative rules, the regulations should explicitly confirm that a banking entity will be deemed to presumptively comply with statutory and regulatory requirements of the hedging exemption so long as its hedging activities are consistent with certain tailored metrics thresholds, which, in the case of hedging activities conducted by market making trading units, will be a subset of the metric thresholds used for monitoring the market making-related activities. These metrics will be tailored and the thresholds will be established as coordinated and agreed with the relevant regulator as part of the overall compliance framework described below.

III. Metrics-Based Compliance Framework

We respectfully propose that the Agencies' approach to implementing both the statutory market making-related activities exemption and the hedging exemptions should permit banking entities to perform their traditional function on behalf of customers in a diverse set of highly intermediated markets under an effective compliance framework. In this regard, we propose that the Proposed Rule explicitly confirm that if a banking entity's trading units' activities are consistent with the applicable metrics and related specific thresholds, the banking entity will be deemed to presumptively comply with statutory and regulatory requirements of those exemptions.[31]

As we describe in more detail below, the Agencies' concerns that the exemptions for those activities not be interpreted in a way that enables proprietary trading to migrate into traditional market making or hedging activities can be addressed through use of an approach that includes both a presumption of compliance for most transactions and activities that conform to specific metrics thresholds, and further review of transactions and activities that fall outside the established specific metrics thresholds, using our reformulated qualitative criteria. We believe that this approach will reduce the need for banking entities to perform trade-by-trade analysis, while allowing for differentiation of impermissible proprietary trading from traditional (and necessary) market making and hedging activities.

Market Making

The core components of our proposed market making-related activities compliance framework are as follows:

- Each banking entity would work with the relevant regulator to identify trading units, each of which would calculate and report its performance under a set of five metrics, compressed from the 17 quantitative requirements in the Proposed Rule (the "Metrics Set"). This Metrics Set, described in more detail below, would generally be applied across trading units, as tailored for each trading unit and in cooperation with the relevant regulator, to account for differences among relevant asset classes, instruments, markets, types of trading activity, business models, operational structures, and the characteristics of the client base served by each trading unit.

[31] This discussion is responsive to NPR Questions 148 and 155.

- The banking entity would then develop the appropriate specific thresholds for each such tailored metric in each trading unit, as coordinated and agreed with the relevant regulator.

- The set of trading instruments permissible for each desk's trading activities will be set forth in trader mandates disseminated to all appropriate personnel. These trader mandates will be reviewed and approved by the trading unit's desk or business head and the banking entity's product control, market risk and compliance functions.

- If a trading unit's activities were to fall outside the specific metrics thresholds that it has developed for the tailored Metrics Set, the banking entity would commence an internal compliance review of the activity in question to determine whether, in light of the facts and circumstances, the activity constitutes impermissible proprietary trading, using qualitative criteria adapted from the current provisions of Section __.4(b) of the Proposed Rule (as modified as discussed above in Section I). In addition, individual institutions could develop or track other metrics that may be relevant to such an internal review.

- The banking entity would document the internal review and the result thereof and, if needed, report its findings to the relevant regulator.

We note that our proposal would not completely preclude after the fact compliance analysis of whether transactions comply with the requirements of the Volcker Rule; rather, it would focus such analysis on transactions and activities that fall outside the specific metrics thresholds and which would therefore be subject to closer review. Our proposal would nevertheless reduce the need for banking entities to perform trade-by-trade analysis, because this approach would provide an effective compliance presumption for most transactions and activities that conform to the specific metrics thresholds. We believe that the Agencies' concerns that the market making exemption not be interpreted in a way that enables proprietary trading to migrate on a disguised basis into traditional market making activities can be best addressed through use of our proposed approach, including further review of transactions and activities that fall outside the established specific metrics thresholds, using the modified qualitative criteria. We believe that our approach will indeed allow for differentiation of traditional (and necessary) market making-related activities from impermissible proprietary trading.

We believe that the Metrics Set should include a compressed version of the 17 quantitative measurements currently set forth in Appendix A of the Proposed Rule, and recommend modifying the retained measurements in order to better differentiate permissible market making activity from impermissible proprietary trading. More specifically, we suggest that the following five quantitative measurements should constitute the Metrics Set:

- Risk and Position Limits. This is the most comprehensive metric to measure and monitor risk taking. It would incorporate the "Value-at-Risk" ("VaR"), "Stressed VaR" and "Risk Factor Sensitivities" metrics in the Proposed Rule, and may also include other quantitative measurements of risk.

- Comprehensive Profit and Loss Attribution, as modified. This is the most comprehensive measure of sources of revenue, and includes as sub-metrics

"Comprehensive Profit and Loss," "Portfolio Profit and Loss," and "Fee Income and Expense."

- Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss. This metric provides the most comprehensive measure of revenues relative to risk and its calculation incorporates the metric "Volatility of Portfolio Profit and Loss" and therefore fully describes all statistical moments of the Portfolio Profit and Loss distribution. The remaining quantitative measures set forth under "Revenue-Relative-to-Risk Measurements" in Section IV.C of Appendix A are less meaningful and descriptive than the skewness and kurtosis metric, and are therefore unnecessary.

- Inventory Risk Turnover, as modified. This metric describes the velocity of the risk turnover and should indicate whether a given trading unit holds risk in a manner consistent with the asset class in which it deals, the type of trading activity in which it engages, and the scale and scope of client trading that it serves.

- Inventory Aging, as modified. This metric identifies positions by holding period. It should indicate whether a given trading unit holds inventory in a manner consistent with the asset class in which it deals, the type of trading activity in which it engages, and the scale and scope of client trading that it serves.

For a more detailed discussion of the 17 quantitative measurements currently included in Appendix A of the Proposed Rule and the reasoning underlying our selection of the foregoing Metrics Set, please see **Annex 1** to this letter.[32]

Hedging

We propose a similar approach to the hedging exemption that would simplify compliance with the statute and permit banking entities to hedge positions arising from their permissible financial intermediation activities across a diverse set of markets, without giving rise to concerns regarding *post hoc* review.

As with our market making proposal, each banking entity looking to rely on the hedging exemption would:

- identify trading units (or levels of the relevant enterprise at which hedging may be conducted across a portfolio of trading units or other cross-entity exposures);

- tailor the "Risk and Positions Limits" element of the Metrics Set for each trading unit;

- develop the appropriate specific metric threshold for each trading unit;[33]

[32] This discussion is responsive to NPR Questions 168 and 367.

[33] Under our proposal, trading units that are engaged in market making would combine their presumptive compliance frameworks for market making and related hedging activities into one framework, with tailoring of the "Risk and Position Limits" element of the Metrics Set and the development of the specific thresholds performed across the market making and related hedging activities.

- commence an internal compliance review of activities falling outside the metric threshold to determine whether, in light of the facts and circumstances, the activity constitutes impermissible proprietary trading, using the qualitative criteria adapted from the current provisions of Section __.5(b) of the Proposed Rule (as modified as discussed above in Section II), and, if relevant, other metrics tracked or developed by individual institutions; and

- document the internal review and the result thereof and, if needed, report its findings to the relevant regulator.

Additionally, the set of permissible instruments set forth in the trader mandates discussed above would include those instruments that have been determined to be acceptable for hedging purposes based on expected correlations to risks that arise from a trading unit's underlying activities.

IV. Trading in Government Obligations

Non-U.S. Government Obligations[34]

We respectfully submit that the Agencies should use their authority under Section 619(d)(1)(J) of the Dodd-Frank Act to exempt trading in non-U.S. government obligations to the same extent permitted for U.S. government obligations and, as further discussed below, exchange-traded futures and options on non-U.S. government obligations. We believe it is appropriate for the Agencies to permit such trading in light of the function that banking entities perform in the markets for non-U.S. government obligations. Such an exemption would also be consistent both with (i) the requirements for the Agencies to exercise their exemptive authority under Section 619(d)(1)(J), given the critical importance of liquidity in the international government debt markets in funding government operations and maintaining international economic stability, and therefore to protect and promote the safety and soundness of U.S. banking entities and the financial stability of the United States more generally, and (ii) the rationale behind the current exemption for trading in U.S. government obligations.[35]

The many linkages between banking entities and national and international markets for government and related obligations demonstrate the particular importance of banking entities in these markets. In addition to the typical intermediation services that dealers provide, in many jurisdictions the role of banking entities in the government debt market is formalized by their status as primary dealers for the obligations of those governments, with these banking entities trading in host government obligations explicitly in support of the fiscal and monetary policies of central banks, and subject to the requirements of those central banks. Banking entities also frequently buy large blocks of non-U.S. government obligations in either the primary or the secondary markets to distribute over time.

[34] For these purposes, we would consider non-U.S. obligations to include obligations issued by supra-national entities such as the European Union and the International Monetary Fund, as well as multilateral development institutions such as the Inter-American Development Bank and the European Bank for Reconstruction and Development.

[35] This discussion is responsive to NPR Question 122.

If banking entities (either U.S. or non-U.S.) are prevented from, or impeded in, trading non-U.S. government obligations, we can expect the same negative effects on such obligations as are described in the market making discussion above, including, in this case, higher funding costs for governments and the resultant destabilizing effects on the international economy as a whole. Because of the interconnectedness of the global economy and the global financial markets, destabilizing effects felt by economies and markets outside the United States would have significant spillover effects and would also undermine the financial stability of the United States and the safety and soundness of U.S. banking entities.

We further submit that these negative effects resulting from failure to provide an exemption for trading in non-U.S. government obligations will likely not be counterbalanced by any increase in safety and soundness. Some trading exposure to even less creditworthy government issuers can be appropriate from a business perspective and would not negatively affect the safety and soundness of an institution as a whole, especially in light of appropriate heightened capital requirements as embodied in the Basel rules.

In addition, non-U.S. government obligations perform central functions at banking entities, as institutions such as Barclays use non-U.S. government obligations to carry out their business, including managing global financial exposure and funding requirements. Exempting trading in non-U.S. government obligations would thus also be analytically consistent with the legislative rationale behind the original statutory exemption for trading in U.S. government obligations – that such obligations "are used as low-risk, short-term liquidity positions and as low-risk collateral in a wide range of transactions, and so are appropriately retained in a trading account."[36]

Section 619 and the Proposed Rule, as currently drafted, do not permit banking entities to perform their liquidity providing roles or carry out their risk management functions with non-U.S. government obligations, because they do not permit unhindered trading in non-U.S. government securities. These roles cannot be fulfilled solely through the offshore trading exemption by non-U.S. banking entities.[37] U.S. banking entities, which are important providers of liquidity for government and related obligations, are entirely ineligible for the offshore trading exemption. The Proposed Rule's current approach to the offshore trading exemption would bar non-U.S. banking entities from using that exemption to trade with U.S. counterparties and on U.S. execution facilities.

Reliance on the market making or hedging exemptions is also impracticable, due to the onerous requirements associated with complying with those exemptions. The existence of a separate exemption for trading in U.S. government obligations supports our contention that the market making and hedging exemptions by themselves are not sufficient to fully permit beneficial trading in non-U.S. government obligations, and the use by the Agencies of their statutory Section 619(d)(1)(J) authority to provide an exemption for such trading is necessary to avoid the negative effects of liquidity constraints in those markets. For the foregoing reasons, we respectfully submit that the Agencies should exempt non-U.S. government obligations from the proprietary trading and other provisions of the Volcker Rule.

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[36] Statement of Senator Merkley, 156 *Cong. Rec.* S5895 (daily ed. July 15, 2010).

[37] Section 619(d)(1)(H), Proposed Rule Section __.6(d).

Exchange-Traded Futures and Options on U.S. and non-U.S. Government Obligations

We also strongly urge the Agencies to use their authority under Section 619(d)(1)(J) to permit trading in exchange-traded futures and options on both U.S. government obligations and on the non-U.S. government obligations discussed above. Not only is it appropriate for the Agencies to permit trading in such instruments in light of the characteristics of the primary and secondary markets for these instruments and the insufficiency of the market making and hedging exemptions in the Proposed Rule to address the operational realities of such markets, but permitting such trading would be consistent both with the legislative intent behind the original exemption in Section 619(d)(1)(A) and with the requirements for the Agencies to exercise their exemptive authority.[38]

Principal trading in exchange-traded futures and options on government obligations has an important function in maintaining the liquidity and price stability of the government obligations markets. The linkage between the markets for U.S. Treasury obligations and futures thereon is a prime example of this relationship. The cash U.S. Treasury and U.S. Treasury futures instruments are so highly interconnected that they are effectively traded as a single market. U.S. Treasury futures, being physically settled contracts, trade almost interchangeably with cash instruments and provide essential additional liquidity to the cash market.[39] In addition, U.S. Treasury futures support a more continuous and observable U.S. Treasuries yield curve. While the most recently auctioned "on the run" U.S. Treasury bonds are very liquid, there are only six benchmark points in the cash instrument yield curve, including a 20 year gap in maturities between 10 year U.S. Treasuries and 30 year U.S. Treasuries. U.S. Treasury futures essentially fill this gap. For example, the Ultrabond future, with a deliverables basket comprised of cash U.S. Treasury bonds with a range of 25-30 years until maturity, acts as a proxy for the "off-the-run" 25 year U.S. Treasury bond. The correlation of prices between the Ultrabond and the 25 year U.S. Treasury bond is close to 100%.[40] In longer-dated maturities, U.S. Treasury futures represent a larger portion of the liquidity in the yield curve than the cash instruments.[41] By virtue of being exchange-traded, with correspondingly high levels of price transparency and concentrated liquidity, U.S. Treasury futures provide an essential complement to the trading of cash U.S. Treasury obligations. Due to the interaction of the markets for exchange-traded futures and options and the cash instruments markets, providing an explicit exemption for trading in exchange-traded futures and options on government obligations would avoid the disruption of the government obligations market that would otherwise result from the Proposed Rule.

The role of dealers in futures liquidity is illustrated by data from the CFTC's *Traders in Financial Futures* report, which shows asset managers persistently long the U.S. Treasuries futures market, and dealers holding offsetting short U.S. Treasury futures positions that facilitate

[38] This discussion is responsive to NPR Question 121.

[39] As an example of the close relationship between these cash and derivative instruments markets, the correlation over January 2012 between daily changes in prices between the 7 year U.S. Treasury note issued in November and the ten year futures contract expiring in March was over 99.8%.

[40] The correlation in daily price changes over the 30 trading days preceding January 31, 2012 between the March bond futures contract and the cash U.S. Treasury bond maturing in August 2027 was 99.94%.

[41] Overall, trading in futures accounts for approximately 55% of average daily U.S. Treasuries volume, but make up nearly 75% of volume for maturities 11 years or longer. *See* **Annex 2**, Exhibit 1.

the asset managers' long positions.[42] While these persistent dealer short positions provide valuable liquidity to the market and enable the asset managers to establish long positions on a cost-effective basis, some of these dealer short positions would appear to be impermissible proprietary trading under the Proposed Rule. Absent the certainty an exemption for this type of dealer activity would provide, this trading by the dealers will be reduced. If the dealers are unable to hold the offsetting futures short positions, the asset managers may choose to hold different assets, such as swaps, which would diminish demand and liquidity for U.S. Treasury futures and, by extension, for the long end of the U.S. Treasury market itself.

In addition, the Board of Governors of the Federal Reserve System (the "Federal Reserve") depends on primary dealers, such as Barclays, to support the U.S. Treasuries market.[43] Primary dealers cannot participate in open market operations and U.S. Treasuries auctions quickly and aggressively without the ability to trade in futures on U.S. Treasuries. Primary dealers must be able to take complex risk-mitigating positions well in advance of open market operations and auctions, and to adjust those positions in real time both before and after the open market operation or auction has occurred. Furthermore, primary dealers would find it difficult to determine the most aggressive price to bid in open market operations and auctions without the price discovery inherent in trading actively in the U.S. Treasuries futures markets. The hedging exemption may not be sufficiently broad to enable primary dealers to prepare for these open market operations. There is no specific risk being hedged by such trades, nor are the trades "established slightly before the banking entity becomes exposed to the underlying risk."[44] Dealers will take short positions in U.S. Treasury futures in the expectation that some portion of their bids will be successful; unless dealers take such short positions, they would run the risk of being long in U.S. Treasury futures (as a result of successful bids) at precisely the point when new supply must be absorbed by the market. These "risk distribution" trades must be entered into well before open market operations actually occur, and with no knowledge regarding whether the primary dealer's bid will be a successful one. Anticipatory purchases of short positions by primary dealers represent a constantly evolving risk mitigation program that takes into account not only a dealer's current exposures and exposures that may result in the near term, but also economic conditions and indicators from the Federal Reserve regarding open market operations that may occur on a relatively long horizon.

We believe that failure to permit trading in exchange-traded futures and options on government obligations on the same basis as in the underlying cash obligations will have significant unintended negative consequences for banking entities and the markets in general. In order for the government debt market to continue to operate as it has, futures must trade interchangeably with cash instruments. Broadening the market making or hedging exemptions will not necessarily provide this certainty.

Any disruption in quality of the U.S. Treasury market could have significant adverse effects on the U.S. government's borrowing costs. Assuming U.S. Treasury issuances in 2011 were typical, we would expect that for each basis point (.01%) increase in yield for a single year's issuances, the United States would have to pay an additional $1.6 billion in interest expense over

[42] *See* **Annex 2**, Exhibit 2.

[43] *See* Federal Reserve Bank of New York Primary Dealer Operating Policy.

[44] NPR at 68875.

the life of the bonds issued that year.[45] While it is difficult to predict the actual increase in yield since other factors come into play (*e.g.*, fiscal situation, political issues, macroeconomic outlook), assuming the Proposed Rule results in a disruption of the U.S. Treasury futures market that leads to a five or ten basis point (0.05% or 0.1%, respectively) increase in yield, interest expenses paid by the United States over the life of all U.S. Treasury securities issued in a given year would increase by $8 billion or $16 billion, respectively. Because much of the demand by the primary dealers for the underlying cash instruments is either directly or indirectly supported by derivative trading strategies, any constraints on trading by primary dealers in exchange-traded futures and options on government obligations will directly impact demand for the cash instruments in the primary markets. In the secondary market, constraints on the liquidity provided by exchange-traded futures and options on government obligations will result in wider bid/ask spreads and higher volatility for government obligation cash instruments. Both of these effects will translate into higher issuance costs for the U.S. government.

The close relationship between cash instruments and exchange-traded futures and options on those instruments is not limited to U.S. government obligations markets. Japanese Government Bonds, German Bunds, and Canadian government obligations are all examples of non-U.S. government obligations for which market transparency and liquidity rests primarily, and at times solely, on trading in futures on those obligations.

For the reasons set forth above, we urge that the Agencies use their authority under Section 619(d)(1)(J) to permit trading in exchange-traded futures and options on U.S. and non-U.S. government obligations to the same extent permitted for the underlying cash obligations. Such an exemption would promote and protect (i) the safety and soundness of U.S. banking entities, many of which have significant investments in U.S. and non-U.S. government obligations and would therefore benefit from maintaining liquidity and lowering volatility in such instruments, and (ii) the financial stability of the United States by enhancing the efficiency of U.S. monetary policy.

Moreover, use by the Agencies of their authority under Section 619(d)(1)(J) to permit trading in exchange-traded futures and options on U.S. and non-U.S. government obligations is also consistent with Congressional intent in providing the original exemption, which Senator Merkley characterized as authorizing transactions in specified instruments "on the grounds that such products are used as low-risk, short-term liquidity positions and as low-risk collateral in a wide range of transactions, and so are appropriately retained in a trading account."[46]

Finally, Congress could not have intended that dealers be significantly hampered in performing their roles in support of the government authorities issuing such obligations. Particularly in light of the implementation of enhanced liquidity requirements that will require financial companies to hold significant amounts of high quality assets (such as government securities), it is crucial that banking entities have the capacity to trade freely in both U.S. and non-U.S. government obligations and exchange-traded futures and options on such obligations.

[45] *See* **Annex 2**, Exhibit 3.

[46] *Supra* at footnote 36.

V. Trading by Non-U.S. Banking Entities Solely Outside of the United States

The Proposed Rule limits the scope of the offshore trading exemption in a manner that is inconsistent with legislative intent and the plain language of the statute, invites reciprocal invasive regulation from international regulators because of its extraterritorial effect, and disadvantages U.S. customers with no clear benefit to the U.S. financial system. We respectfully urge that the requirements that (i) no party to a transaction may be a resident of the United States, and (ii) transactions must be executed wholly outside of the United States be omitted from the final rules implementing the offshore trading exemption.[47]

The Proposed Rule's unnecessarily narrow implementation[48] of the offshore trading exemption is consistent neither with the clear language of Section 619(d)(H) of the Dodd-Frank Act, which focuses on the location of the trading activity and the jurisdiction of the banking entity, nor with Congressional intent. Senator Merkley stated, with respect to the offshore trading and funds exemptions, that those exemptions "recognize rules of international regulatory comity by permitting non-U.S. banking entities, regulated and backed by non-U.S. taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant non-U.S. law."[49] To remain consistent with these principles, the Agencies should implement the clear use of the term "trading" in the statute, which refers to an activity conducted by the banking entity, rather than expanding the scope of the statutory requirement to limit activities conducted by individuals and entities other than banking entities. For example, we believe that the plain language of the statute should be read to permit a non-U.S. banking entity that otherwise complies with statutory requirements to trade freely on a non-U.S. exchange (for example, in the United Kingdom), without unwarranted regard for the actions of third parties, *e.g.*, any U.S. persons who may choose to trade on a U.K. exchange.

We recognize that this less restrictive construction of the offshore trading exemption presents competitive concerns for U.S. banking entities that will have a narrower range of exemptions on which to rely in comparison to their non-U.S. counterparts. However, we emphasize that this is a result of Congressional judgment in explicitly providing the additional offshore trading and funds exemptions for non-U.S. banking entities. We respectfully submit that the Agencies, in considering whether to remove the "party" and "execution" limitations from this exemption, should instead focus on the potential repercussions for U.S. markets, including a substantial migration of exchange trading activity away from the United States, and on the ramifications for U.S. customers described below.

Furthermore, and contrary to the principles of Senator Merkley's statement, the Proposed Rule's approach will have an inappropriate extraterritorial impact and is unduly invasive in imposing its substantive requirements and burdensome compliance regime on the operations of non-U.S. banking entities outside of the United States. The regime envisioned in the Proposed Rule would operate far in excess of equivalent existing home country regulatory regimes, inviting reciprocal invasive regulation from international regulators. Rather than taking a cooperative and

[47] This discussion is responsive to NPR Question 136.

[48] The Proposed Rule limits reliance on the exemption based on whether the relevant transaction has *any* U.S. nexus, barring any trade where any party to the transaction is a resident of the United States or where such trade is not executed wholly outside of the United States. Proposed Rule Section __.6(d).

[49] Statement of Senator Merkley, 156 *Cong. Rec*. S5895 (July 15, 2010).

consultative approach similar to the cross-border prudential regulation efforts such as Basel III, the Proposed Rule's application disregards non-U.S. regulators' own preferences in supervising home country banking entities. The Agencies should instead continue to pursue a cooperative and consultative approach reflecting appropriate deference to ongoing international efforts to address concerns regarding banking entity risk.

As a practical matter, we believe that the criteria regarding no U.S. "party" and no U.S. "execution" will disrupt the price and availability of services provided to U.S. customers. To the extent that non-U.S. banking entities choose to rely on the offshore trading exemption only, U.S. customers will, by definition under the current proposed requirements, lose access to non-U.S. banking entities' services. Non-U.S. banking entities that continue to provide such services to U.S. customers at all (in reliance on other exemptions such as the market making exemption, and possibly in connection with an artificial and inefficient organizational bifurcation of non-U.S. trading operations) will incur heightened compliance costs, and their U.S. customers are likely to pay prices less advantageous than those charged to non-U.S. customers. As a result, U.S. asset managers and corporate customers seeking investment, risk management and hedging products in non-U.S. local markets will be financially disadvantaged relative to non-U.S. market participants. They may lose access to their preferred service providers, have a narrower set of options for service providers charging less competitive rates, or be faced with an inability to trade on non-U.S. exchanges, which, to ensure the availability of the offshore trade exemption to non-U.S. banking entities, would need to prohibit trading by all U.S. investors.

These harms will not be balanced by an offsetting decrease in risk to U.S. financial institutions, which would already need to comply with the requirements of an available exemption in order to participate in any trading activity. All of the risks to non-U.S. banking entities associated with activities conducted in reliance upon the offshore trading exemption will reside offshore, and the Volcker Rule was never intended to restrict the availability of trading options for corporate and other U.S. entities not captured by the Volcker Rule. In order to prevent the harm to U.S. customers described above and to effectuate the intent of Congress, the Agencies should remove the requirements that no party to a transaction may be a resident of the United States and that transactions must be executed wholly outside of the United States from the final rules.

VI. Provisions Relating to Covered Fund Investments and Relationships

Our fundamental concern with the funds-related provisions of the Proposed Rule as currently drafted is rooted in the complex interplay between three core elements: (i) the definition of "covered fund," (ii) the definition of "banking entity," and (iii) the Proposed Rule's approach to the so-called "Super 23A" provision.[50] Because each of these elements has a multi-functional role in the Proposed Rule, we believe that, in some contexts, they will combine to result in presumably unintended and far-reaching adverse consequences.

[50] Proposed Rule Section __.16(a)(1).

Definition of "Covered Fund"

We respectfully submit that the Agencies have defined the term "covered fund"[51] too broadly to be consistent with statutory intent. In combination with the application of Super 23A, this overly broad definition will cause banking entities to face unwarranted investment restrictions, restrictions on affiliate transactions, and high costs of compliance with respect to subsidiaries, affiliates, joint ventures, club arrangements, consortium deals, and investments that are not similar to hedge funds or private equity funds as a substantive matter, but that may be covered by the Proposed Rule's definition of "covered funds" simply due to technical provisions of the 1940 Act (and related regulations). We note that while the issues presented by the Proposed Rule with respect to certain of these types of entities may be somewhat ameliorated through certain of the exemptions for permitted activities provided for in the Proposed Rule (*e.g.*, investments in and sponsorship of certain joint ventures and wholly-owned subsidiaries would be permitted under the Proposed Rule), the proposed exemptions are too narrow and do not provide practical relief from the impact of being definitionally deemed a "covered fund" and the consequent application of the Super 23A prohibitions. We support the observations made in this area in the comment letters submitted by the Institute of International Bankers, a trade association of which Barclays is a member (the "IIB"), and by SIFMA regarding the "covered funds" provisions of the Proposed Rule (the "SIFMA Funds Letter"), and we believe that the Agencies should (i) define "covered funds" based on a combination of reliance on Sections 3(c)(1) and 3(c)(7) of the 1940 Act and the presence of the traditional characteristics of hedge or private equity funds, and (ii) not include as "similar funds" (and therefore exclude from the definition of "covered fund") any non-U.S. entities that do not have the traditional characteristics of hedge or private equity funds.[52]

Without this modification, we would expect broad negative effects on certain publicly offered (and highly regulated) non-U.S. funds, covered bond programs, traditional credit funds, asset-backed securitizations (including asset-backed commercial paper issuances), resecuritizations, entities acquired in satisfaction of debt previously contracted ("DPC Entities"), and other widely-used vehicles and entities that are substantively not hedge funds or private equity funds. As elaborated in the SIFMA Funds Letter and the comment letter submitted by the IIB (the "IIB Letter"), treating such vehicles as covered funds and requiring banking entities to conform their investments in and sponsorship of such vehicles to the narrow list of permitted activities is unduly limiting, and subjecting them to the Super 23A limitations on transactions with their banking entity sponsors would be unnecessarily disruptive.[53]

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[51] The Volcker Rule's provisions in this area generally apply to a banking entity's relationships with "hedge funds" and "private equity funds" which are defined as issuers that (i) would be investment companies for the purposes of the Investment Company Act of 1940 (the "1940 Act"), but take advantage of Sections 3(c)(1) or 3(c)(7) of the 1940 Act to avoid registration, and (ii) such similar funds as the Agencies may provide for by regulation. See Section 619(h)(2). In defining "covered fund," the Agencies have adopted the statutory definition of "hedge funds" and "private equity funds" and expanded the definition to include (x) commodity pools and (y) issuers organized or offered outside of the United States that would be covered funds were they to be organized or offered under the laws of, or offered to the residents of, the United States ("foreign equivalent funds"). See Proposed Rule Section __.10(b).

[52] This discussion is responsive to NPR Questions 221 and 224.

[53] This discussion is responsive to NPR Questions 227 and SEC-3.

As an example, non-U.S. banking entities often have subsidiaries that, due to factors including non-U.S. legal or funding requirements, are not wholly owned, and either rely on Sections 3(c)(1) or 3(c)(7) to avoid registration under the 1940 Act, or would rely on such sections if such subsidiaries had a U.S. nexus or could meet the hypothetical scenario embodied in the definition of "foreign equivalent fund" ("Subsidiary Fund Entities"). Such subsidiaries are not maintained for the purposes of pooled investment, but rather for other legitimate corporate, organizational, or enterprise-wide business purposes, such as inter-company financing and liquidity or risk management. Unless the Proposed Rule's definition of "covered fund" is amended, banking entities would be required to undertake onerous periodic reviews of each of these subsidiaries, in addition to each wholly-owned subsidiary, at great cost, to determine whether any such entity would be a covered fund and therefore impermissible unless another exemption is found. The allocation of compliance and risk management resources to this exercise would undermine the goals of the Volcker Rule.[54]

Super 23A

The final rules' implementation of Super 23A should not cover transactions between a non-U.S. banking entity and a non-U.S. covered fund eligible for the offshore funds exemption. The extraterritorial application of Super 23A currently contemplated by the Proposed Rule would be quite problematic and harmful to the non-U.S. operations of non-U.S. banks. Minimizing these types of disruptions is consistent with the policy objectives of the offshore funds exemption.[55]

In addition, to the extent that the Agencies determine not to redefine the term "covered fund" to exclude any of the types of entities discussed above (or that are identified by reference to either the IIB Letter or the SIFMA Funds Letter) but rather to continue to exempt them from the general fund-related prohibitions, we submit that the Agencies should nevertheless use their exemptive authority to provide that transactions between banking entities and their related "exempted" funds will not be subject to Super 23A. We note that the text of the statute requires only that Super 23A be applied to relationships with "hedge funds and private equity funds," and submit that the severe implications of applying this provision to the types of entities that do not have the characteristics of private equity or hedge funds weighs heavily in favor of the Agencies using their exemptive authority to prevent the types of disruptions that would result from application of Super 23A outside of that context.[56]

For example, ownership interests in a DPC Entity are often acquired at a time when the DPC Entity is in substantial financial distress, and the banking entity either may already have lending relationships with that DPC Entity that are not entirely extinguished or could determine that additional financing (such as a bridge facility) or a substantial amendment to an existing credit facility (or extension of the term thereof) will prudentially enhance the banking entity's prospects for obtaining a return on its collateral and any other outstanding credit extensions. The exemption provided for acquiring ownership interests in or sponsoring a DPC Entity[57] nonetheless refers to such an entity as a "covered fund," and such extensions of credit would

[54] This discussion is responsive to NPR Questions 291 and 311.

[55] This discussion is responsive to NPR Question 294.

[56] This discussion is responsive to NPR Question 314.

[57] Proposed Rule Section __.14(b)(i).

appear to render a banking entity in violation of the Proposed Rule under its construction of Super 23A.[58]

Definition of Banking Entity

Regardless of whether a given type of entity is ultimately excluded from the definition of "covered fund" in the final rules, we urge that the Proposed Rule's definition of "banking entity" should be modified to explicitly exclude all of the types of entities discussed above in connection with the over-broad definition of "covered fund." We believe this is a necessary technical correction, because without such a correction fund entities that are otherwise permitted by an exemption to the Volcker Rule, to the extent they were deemed to be affiliates of the banking entity in question, would themselves become banking entities and therefore subject to all of the prohibitions and restrictions set forth in Section 619 and the Proposed Rule. We believe that this result could not have been intended because each of these types of entities may need to engage in activities generally prohibited by the Volcker Rule for inherent or operational reasons with which the Volcker Rule was not presumably intended to interfere. In this regard, we support the positions expressed in the SIFMA Funds Letter and the IIB Letter with respect to the types of entities which should be excluded from the "banking entity" definition, and furthermore urge that such definition should exclude Subsidiary Fund Entities, credit funds, non-U.S. public funds, credit funds, asset-backed issuers (including issuers of asset-backed commercial paper), and DPC Entities.[59]

VII. Effectiveness and Implementation

The Proposed Rule's current requirement that banking entities implement relevant compliance[60] programs and undertake specified reporting and recordkeeping obligations as of July 21, 2012 is both unrealistic and undesirable. We respectfully submit that the Agencies should allow the reporting, recordkeeping and compliance program requirements to be phased in over the Volcker Rule's conformance period. This phase-in process should include identification of trading units, tailoring of the Metrics Set, and development of appropriate specific metrics thresholds.

Given that banking entities will not know what compliance, reporting, and recordkeeping obligations will need to be adhered to, and on what basis, until the release of the final rules, we believe that meaningful implementation of the requirements specified above by July 21, 2012 will simply be impossible.

Setting up a compliance program will require the creation of new compliance and risk management policies and procedures, a system of internal compliance controls, training of trading staff and managers, independent testing by internal audit or outside parties, and potential information technology enhancements. The need for an offshore compliance program will place a further strain on non-U.S. banking entities which simultaneously have to comply with home country regulatory requirements; such entities will face increased compliance costs because of both additional compliance requirements and the difficulty of dealing with potentially

[58] This discussion is responsive to NPR Question 316.

[59] This discussion is responsive to NPR Questions 5 and 6.

[60] NPR at 68855.

inconsistent regulatory regimes. Based on their supervisory experience, the Agencies should be aware of the time and expense that is entailed in creating and implementing such infrastructure.[61]

To address these challenges, we propose that the Agencies provide that implementation plans should be completed by banking entities by a date that allows for a reasonable timeframe following release of the final rules. Further, the proper tailoring of the Metrics Set for each trading unit and the development of the related specific thresholds and appropriate policies and procedures will be significantly more challenging and time consuming, and therefore should be implemented over the entire length of the conformance period, as coordinated and agreed with the relevant regulator. The final rules should allow any quantitative metrics ultimately required to be calculated and reported to likewise be implemented over the entire length of the conformance period, in consultation with the relevant regulator.[62]

We note that there is no statutory provision that prevents the Agencies from taking the approach outlined above. Section 619(e) of the Dodd-Frank Act requires the Agencies to issue regulations "regarding internal controls and recordkeeping in order to insure compliance with this section," but does not prevent the Agencies from setting the timeframe for implementing those rules on a staggered basis. The compliance rulemaking provided for in the statute is meant to be "part of the rulemaking [regarding the substantive requirements of Section 619](b)(2)."[63] As with the substantive requirements, the compliance-related requirements referenced above can utilize the conformance periods allotted by Congress in Section 619(c)(2).

In addition, the Agencies' statement in the Preamble that banking entities should bring their activities and investments into compliance with the Volcker Rule and the Agencies' rules thereunder "as soon as practicable within the conformance periods" results in a lack of clarity for banking entities. The statute itself explicitly provides for an initial two-year conformance period for all banking entities, subject to up to three one-year general extensions.[64] The timing of conformance is an area in which affected banking entities will need certainty, as the requirements of the Volcker Rule will require many banking entities to make significant organizational changes while continuing to conduct their businesses in a safe and sound manner, with confidence in the time periods they have to make these changes.

Each banking entity seeking to bring its activities into conformance with the Volcker Rule and the final rules should be permitted to choose its own efficient and effective path to implementation and to implement its compliance plan over the course of the whole conformance period, in each case, in a reasonable and prudential manner and in consultation with the relevant regulator. In doing so, each banking entity, to the extent applicable, should be permitted, if it chooses, to implement conformance incrementally with respect to each of the asset classes in which it trades, each of the different jurisdictions or regions where it is located, and/or each of the metrics in the Metrics Set, with ample time for consultation with the relevant regulator. Given the change in operations that certain banking enterprises will undergo, they must be given the opportunity, as contemplated by the statute, to make decisions regarding their plan to

[61] This discussion is responsive to NPR Question 2.

[62] This discussion is responsive to NPR Questions 3 and 4.

[63] Section 619(e)(1).

[64] Section 619(c)(2), (3).

implement compliance in a considered manner. Banking entities would also share, within a reasonable time after the publication of the final rules, a compliance implementation plan with the relevant regulator, and would otherwise welcome constructive supervisory input over the course of the conformance period based on that plan.

Finally, we note that the final rules promulgated by the Federal Reserve under the conformance period provisions of the Volcker Rule already impose specific guidelines on banking entities for bringing their activities and investments into conformance. Any banking entity whose efforts to conform its activities ultimately extend beyond either the initial conformance period or any extension granted will need to apply to the Federal Reserve for an extension at least six months before the end of its existing conformance period, and will be required to provide information regarding its conformance efforts to the Federal Reserve in connection with any such application.[65]

VIII. Additional Topics

Inter-Agency Co-ordination

The Proposed Rule does not state which Agency has primary interpretive, supervisory and enforcement authority over a given banking entity with respect to the Volcker Rule where a single enterprise would be subject to the authority of multiple Agencies. For example, a banking entity that, on a consolidated basis, is both a broker-dealer and a swap dealer could be subject to Volcker Rule supervision by more than one regulator and would thus be subject to overlapping supervision and enforcement across the enterprise. Where a single enterprise would be subject to overlapping supervision, enforcement and interpretation, the enterprise's compliance with the restrictions of the Volcker Rule could be subject to uncertainty and conflicting interpretive guidance, which would impose duplicative, unnecessary, and costly compliance and supervision burdens on banking entities, as well as their regulators.

We believe that, in order to alleviate the foregoing concerns, there should be a single Agency that has responsibility for each enterprise with respect to administration (including supervision, examination, compliance, and enforcement) of the Volcker Rule, and that this should ideally be the primary umbrella Federal regulator of the enterprise.

Support for Comments Submitted by Trade Associations

This letter focuses on a number of areas that are of particular concern to Barclays and with respect to which we believe Barclays can provide a valuable perspective. There are, however, various additional issues raised by the Proposed Rule that, in the interest of brevity, we have not specifically addressed herein because we generally agree with many of the views ably expressed in the comment letters being contemporaneously submitted to the Agencies by SIFMA, the IIB and the American Securitization Forum.

[65] *See* Subpart E of the Proposed Rule, incorporating almost verbatim the Federal Reserve's final rules regarding conformance periods, previously promulgated by the Federal Reserve on February 8, 2011. 76 *Fed. Reg.* 8265 (Feb. 14, 2011).

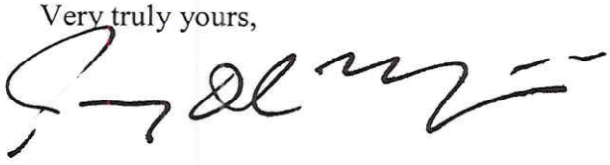
IX. Conclusion

We recognize and endorse the worthwhile goals underlying the Volcker Rule, including promoting the safety and soundness of financial institutions and enhancing the stability of the US financial system. Nevertheless, the pursuit of such important purposes should not lose sight of other important policy considerations. We therefore strongly believe that the final rules implementing the Volcker Rule should be crafted in such a way as to promote international harmonization and avoid unnecessary decreases in liquidity, increases in volatility, increases in expense of services for customers of banking entities, and disruptions in the markets. Our core concern is that the Proposed Rule, as currently drafted, will significantly and negatively impact market quality, particularly in markets that are not highly liquid and exchange-traded. Market making in relatively illiquid markets requires a different model based on retention, as the circumstances demand, of more principal risk, both in terms of the size of inventory and the length of time that inventory is held. The final rules must reflect this different model if market making in less liquid markets is to continue in an efficient form, and market makers are to be able to provide liquidity, thereby lowering costs of capital for issuers and supporting the recovery of global economies. We have therefore proposed an approach to the market making exemption and to the hedging exemption that would provide banking entities with a means of effectively and efficiently complying with the purpose of the Volcker Rule to prohibit proprietary risk taking, while preserving their crucial role in financial intermediation.

Our other comments are likewise aimed at mitigating potential negative effects of the Proposed Rule's restrictions on customers of banking entities where such restrictions are unnecessary to effectuate the aims and language of the statute — specifically, the potential loss of access by U.S. customers to the services of non-U.S. banking entities due to an overly strict offshore trading exemption, the issues arising from the interrelation of certain portions of the offshore funds exemption, and the market disruption that may be caused by an overly aggressive implementation schedule. Finally, we urge the Agencies to permit trading in non-U.S. government obligations to the same extent permitted for U.S. government obligations, and to permit trading in exchange-traded futures and options on all thus exempted U.S. and non-U.S. government obligations from the general prohibition on proprietary trading. We respectfully submit that the foregoing changes to the Proposed Rule are fully consistent with both the letter and the spirit of the Volcker Rule.

* * *

Very truly yours,



Jerry del Missier
Co-Chief Executive
Barclays Capital

Annex 1

Metrics Set

In this Annex, we set forth our reasoning regarding the composition of the Metrics Set, the proposed modifications to the metrics included in the Metrics Set as compared to the set of 17 metrics set forth in Section III.A of Appendix A to the Proposed Rule, and specific suggestions as to the tailoring of particular quantitative measurements included in the Metrics Set.[66]

Risk-Management Measurements

We recommend that "Risk and Position Limits" be included in the Metrics Set as the sole metric to measure and monitor risk, and that the other proposed metrics in the "Risk-Management Measurements" category[67] not be included. "Risk and Position Limits" is the most comprehensive metric to measure and monitor risk taking. The calculations of "Risk and Position Limits" for purposes of the Metrics Set would not only incorporate the measurements for "VaR," "Stressed VaR," and "Risk Factor Sensitivities," but may also include other relevant measurements (*e.g.*, market value, notional amount). The recommended quantitative measurements that a trading unit would use to calculate "Risk and Position Limits" depend, *inter alia*, on asset class and product type and the trading unit's corresponding key risk factors. Acceptable levels of risk for any given trading unit would be tailored relative to the specific markets in which the trading unit is active and the scale and scope of the client franchise of the trading unit, as both factors determine the level of principal risk taking required to facilitate client demand. "VaR Exceedance" reveals only the accuracy of the VaR model, not the trading unit's trading intent or actual risk taken, and this should not be used.

Source-of-Revenue Measurements

We recommend that "Comprehensive Profit and Loss Attribution" be included in the Metrics Set and that the other proposed metrics in the "Source-of-Revenue Measurements" category[68] should be excluded. "Comprehensive Profit and Loss Attribution" is the most comprehensive metric for measuring sources of revenue and includes as sub-metrics "Comprehensive Profit and Loss," "Portfolio Profit and Loss," and "Fee Income and Expense." We note that for purposes of reporting "Comprehensive Profit and Loss Attribution," the component "Spread Profit and Loss" (defined in Appendix A to the Proposed Rule to be a portion of "Comprehensive Portfolio Profit and Loss") should not be required as a separate element. Given the fact that two-sided continuous trading does not exist in many markets, changes in the value of a portfolio cannot be broken up into distinct "spread" and "risk factor" components. Acceptable levels of profit and loss for "Comprehensive Profit and Loss Attribution" would be tailored with respect to each trading unit relative to the market microstructure of the specific markets in which the trading unit is active, (*e.g.*, commission-based vs. trading-based revenue) and the scale and scope of the

[66] This discussion is responsive to NPR Questions 174 and 367.

[67] *See* Section IV.A of Appendix A to the Proposed Rule.

[68] *See* Section IV.B of Appendix A to the Proposed Rule.

client franchise of the trading unit. Both factors determine level and composition of the revenue stream.

Revenue-Relative-to-Risk Measurements

We recommend that "Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss" be included in the Metrics Set. Its calculation incorporates (and therefore obviates the need for a separate calculation of) the metric "Volatility of Portfolio Profit and Loss" and therefore fully describes all statistical moments of the Portfolio Profit and Loss distribution. As this metric is the most comprehensive metric in the "Revenue-Relative-to-Risk Measurements" category, other metrics are unnecessary.[69] We are concerned that "Unprofitable Trading Days Based on Comprehensive Profit and Loss" and "Unprofitable Trading Days Based on Comprehensive Portfolio Profit and Loss" can trigger a reduction in liquidity in volatile markets or in rapidly declining markets, when risk taking by market makers is essential. We believe these metrics will result in market makers being less likely to take client-facing positions due to reluctance to incur unprofitable trading days that could indicate the presence of an impermissible activity, despite the actual utility and purpose of such trades in providing liquidity to customers.[70]

Customer-Facing Activity Measurements

We recommend that "Inventory Risk Turnover" and "Inventory Aging" generally be included in the Metrics Set, and that the "Customer-Facing Trade Ratio" metric not be included.[71] The "Inventory Risk Turnover" metric describes the velocity of the risk turnover, and the "Inventory Aging" metric identifies positions by holding period. Both metrics should indicate whether a given trading unit holds risk and inventory consistently with the asset class in which such trading unit deals, the type of trading activity in which the trading unit engages, and the scale and scope of client activity that such trading unit serves. Nonetheless, both of these metrics should be modified in order to be meaningful.

The definition of "Inventory Risk Turnover" in Appendix A of the Proposed Rule may result in a measurement that does not accurately reflect risk turnover throughout the calculation period (*e.g.*, result in a measure showing very high or infinite turnover if the net risk exposure at inception is low or zero) since the denominator is based on the static measure of holdings "at the beginning of the calculation period." As a remedy, we suggest calculating "Inventory Risk Turnover" for each trading unit using:

- the sum of the absolute values of the risk factor sensitivities associated with each transaction over the calculation period as the numerator, and

[69] *See* Section IV.C of Appendix A to the Proposed Rule.

[70] *See* for example the research paper which discusses the relationship between risk metrics and liquidity: "Liquidity and Risk Management," Nicolae Garleanu and Lasse Heje Pedersen (2007), The American Economic Review, P&P at 193-197.

[71] *See* Section IV.D of Appendix A to the Proposed Rule.

- the average of the absolute values of net risk factor sensitivities over the calculation period as the denominator.

Net risk factor sensitivities would be calculated at close of business on each trading day of the calculation period. The proposed definition eliminates the bias introduced by using risk at inception in the denominator and therefore provides a more robust metric.

Application of the "Inventory Aging" metric is only appropriate for cash products and should not be used for trading units engaged in transactions in other covered financial positions, such as derivatives, because, for example, this measure would inappropriately favor a 1-year interest rate swap over a 10-year interest rate swap. This metric may also inappropriately require customer-facing derivatives contracts to be unwound if an aging specific metric threshold is reached.

Both the "Inventory Risk Turnover" and (if applicable) "Inventory Aging" metrics would be tailored based on the market for a particular asset class and market conditions of the markets where the relevant trading unit is active, because turnover may be lower and aging levels higher in less liquid markets where a higher level of risk is routinely retained by market makers.

The "Customer-Facing Trade Ratio" metric (as defined in Appendix A of the Proposed Rule) should not be included in the Metrics Set since it does not provide a useful measure of customer-facing activity. As an initial matter, the number of transactions executed over a calculation period does not provide an adequate measure for the level of customer-facing trading and should be replaced by a risk-aware metric (*i.e.*, risk factor sensitivities). For example, if a trading unit has entered into a large trade with a customer that needs to be hedged through four transactions with non-customer counterparties, the customer-facing trade ratio of 1 to 4 would send a false signal that the trading unit might be engaging in impermissible activities. A risk-aware metric would result in a ratio close to 1 and more accurately capture the degree of customer activities. The proposed "Customer-Facing Trade Ratio" metric also does not adequately reflect realities of the inter-dealer market, where part of a trading unit's role as a market maker is to provide critical liquidity and price discovery to the marketplace. The metric would indicate that those activities are not related to customer trading and could be interpreted as impermissible trading. Additionally, the Customer-Facing Trade Ratio metric provides false signals regarding trading units that engage in hedging activities. Hedging transactions may be internalized, or may be executed externally with non-customers such as an exchange. A trading unit which engages in risk reduction through these activities would therefore send the false signal that it engages in relatively less customer-facing trading activity.

Payment of Fees, Commissions, and Spread Measurement

We believe that the "Pay-to-Receive Spread Ratio" metric[72] should not be included in the Metrics Set because its calculation incorporates the "Spread Profit and Loss" metric that, as discussed above, does not provide meaningful evidence of impermissible proprietary risk taking.

[72] *See* Section IV.E.1 of Appendix A to the Proposed Rule.

Annex 2

Exhibits to Trading in Derivatives on Government Obligations

Exhibit 1

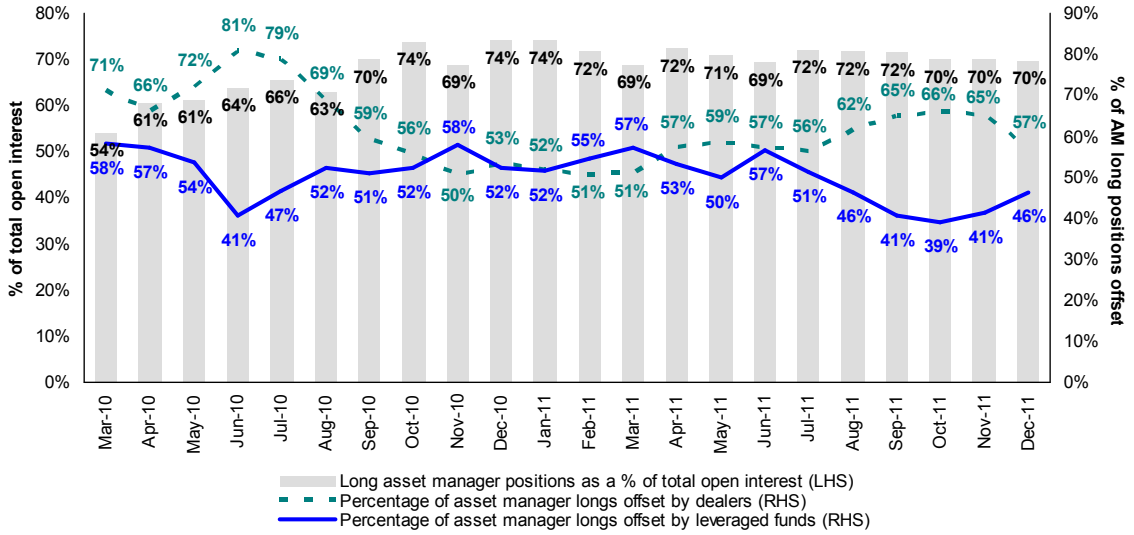
Average Daily Volumes	0-3yr	3-6yr	6-11yr	11+ yr	**Total**
Daily Futures Volumes (in millions)[73]	54,413	62,534	111,190	38,985	**267,122**
Inter-dealer Treasury market volume (Fed stats, coupon securities)[74]	76,828	60,922	61,504	13,357	**212,611**
Futures volume as a percentage of the total market	41.5%	50.7%	64.4%	74.5%	**55.7%**

[73] Source: Bloomberg.

[74] Source: http://www.newyorkfed.org/markets/statistics/msytd.pdf.

Exhibit 2

Average asset manager long positions in long-term U.S. Treasury bond futures contract from March 2010 through December 2010 and offsetting dealer and leveraged fund positions[75]



# of traders	3/10	4/10	5/10	6/10	7/10	8/10	9/10	10/10	11/10	12/10	1/11	2/11	3/11	4/11	5/11	6/11	7/11	8/11	9/11	10/11	11/11	12/11
AM Longs	9	8	12	15	16	19	25	25	24	26	28	28	33	31	33	34	35	35	36	37	38	37
Dealer Shorts	2	5	6	6	8	7	7	9	11	11	10	11	9	12	11	10	10	13	14	14	12	11
Lev fund Shorts	7	8	8	9	10	10	11	11	13	12	13	16	17	16	17	18	17	16	15	12	10	11

[75] Source: CFTC Traders in Financial Futures report; average monthly data calculated from weekly commitments published Mar 2010 through Dec 2011.

Exhibit 3

Estimates for increase in U.S. Treasury interest expenses for every basis point in extra yield

Treasury instrument	2-year	3-year	5-year	7-year	10-year	30-year	5-year TIPS	10-year TIPS	30-year TIPS	**TOTAL**
2011 gross issuance[76]	420	384	420	348	264	168	38	70	23	**2,135**
Extra yield	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	
Incremental annual interest expense per basis point[77]	42	38	42	35	26	17	4	7	2	**214**
Number of years until maturity	2	3	5	7	10	30	5	10	30	
Incremental interest expense over life of security[78]	84	115	210	244	264	504	19	70	69	**1,579**

[76] Source: www.treasurydirect.gov; (in USD billions).

[77] (in USD millions).

[78] (in USD millions).