Financial Services Authority

From the Chairman
Adair Turner

Direct line: 020 7066 3000
Local fax: 020 7066 1011

Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
Eccles Board building
C Street NW (between 20th & 21st Streets)
Washington DC 20551
USA

08 February 2012

Our Ref: CW

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

Dear Ben

I would like to take the opportunity, following the Chancellor of the Exchequer's letter to you (23 January 2012), to comment further on the proposals published last year by the U.S. regulatory agencies regarding banks' proprietary trading and relationships with hedge funds and private equity funds (the Volcker Rule). As you are aware, the Financial Services Authority is the United Kingdom's integrated financial regulator responsible for prudential and conduct of business supervision. As such, it has statutory responsibility for supervising U.K.-incorporated banks, several of whom have material operations in the U.S. and act as major counterparts to U.S. banks. It is also responsible for the oversight of U.K.-based asset managers and U.K. financial markets.

We sympathise with the central intent of the Volcker Rule as one of several measures in the Dodd-Frank Act aimed at enhancing the resilience of U.S. banks. There is wide recognition globally of the need to take strong action that will help to ensure we avoid any repetition of the stresses that the banking sector has experienced in recent years. This has prompted considerable efforts internationally, and we have worked closely within the Financial Stability Board and the Basel Committee with U.S. colleagues and others to this end. In the U.K., the recommendations of the Independent Commission on Banking (ICB), which have now been accepted formally by the government, will result in additional domestic reform measures. A shared objective of both the U.S. and the U.K. domestic reform programmes is to restrict the ways in which trading activity can threaten the safety and soundness of commercial banks – in our case, the ICB proposals envisage ring fencing retail and SME deposits and overdrafts (at a minimum) from wholesale and trading operations.

However, while we concur with the rationale of imposing restrictions on proprietary trading by U.S. firms, we believe that the proposed approach to implementation will have extra-territorial effects on firms that are already subject to overseas regulatory regimes, and may

Permitted activities relating to government bonds and liquidity management

The U.K. Chancellor has already referred to the adverse impact that the Volcker Rule could have on sovereign debt markets. Your published proposals include an exemption for trading in U.S. government obligations and those of certain U.S. public agencies. As a prudential and market regulator, we can see the logic of this exemption. Your consultation document asks whether the U.S. regulatory agencies should adopt an additional exemption for proprietary trading in the obligations of foreign governments. We believe that the same logic which has led you to exempt U.S. government bonds applies to similar overseas obligations (such as U.K. government bonds).

Government debt and related obligations are a major constituent of the banking sector's liquid assets. It is therefore essential that banks are able to manage the stock of liquid assets dynamically over time. In addition to the exemption for U.S. government bonds, the proposals include an exclusion for positions acquired or taken for liquidity management purposes (but subject to various tests). This issue is an important one from a safety and soundness perspective. Consequently, we wish to underline the importance of this and the other exclusions (e.g. certain repurchase arrangements or those relating to transactions by foreign banks), and the importance of applying them in a manner that does not constrain banks, particularly those outside the U.S., from engaging in active liquidity management. In addition to bonds issued by governments outside the U.S., this issue is also relevant to other assets that are accepted as liquid reserves under local legislation. Trading liquidity in some markets will be less deep than that for U.S. Treasury obligations; it is therefore important that the tests for assessing bona fide liquidity management take account of this.

Foreign banking entities exemption and market making exclusions

Section 619 of the Dodd-Frank Act includes an exemption for transactions that take place outside of the U.S. In the implementation proposal, the U.S. agencies have adopted a tightly-drawn definition of an overseas trade, so that for a transaction to take place outside the U.S. each of four conditions must apply: (i) the transaction is conducted by a banking entity that is not organised under U.S. law, (ii) no party to the transaction is a U.S. resident, (iii) no personnel of the banking entity that is directly involved in the transaction is physically located in the U.S.; and (iv) the transaction is executed entirely outside the U.S.

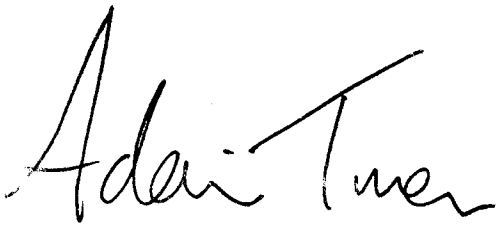
As a general comment, we do not believe any implementing measure should seek to impose a narrower definition of a transaction involving foreign banking entities than is required by primary legislation. More specifically, the consultation text asks whether respondents would like further clarification about the scope of these terms. We believe the U.S. agencies should achieve an outcome where the use of custody and settlement services, trade facilitation services or other infrastructure provided or supported by a U.S. entity is not sufficient by itself (i.e. without the assumption of the risks and potential profit opportunities of proprietary trading) to call into question a transaction's eligibility for the foreign banking entities exemption. This appears consistent with the safety and soundness goals at which the Volcker Rule aims.

Questions also arise as to the interaction of the market maker exemption and the requirements as they relate to foreign banking entities in non U.S. markets. If a U.K.-incorporated bank with a U.S. affiliate engages in a transaction in the U.K., or a third country, with a U.S. bank that acts as a market maker under the market maker exemption, it will seemingly be unable to take account of any exemption relating to trades outside the U.S. We would be interested in exploring or obtaining clarification on how such transactions will be viewed. Uncertainty about the delineation of the exemption requirements might reduce some useful trading activity without yielding off-setting prudential gains.

I and my colleagues welcome the opportunity to comment and are happy to engage in further dialogue.

I am copying this letter to Chancellor of the Exchequer, Her Majesty's Treasury and to the Heads of the OCC (John Walsh), SEC (Mary Schapiro), FDIC (Martin Gruenberg) and CFTC (Gary Gensler).

Yours



Adair Turner