November 5, 2010

Comments on the US Volcker Rule

Japanese Bankers Association

The Japanese Bankers Association is an organization that represents the banking industry and is comprised of 139 domestic banks and 45 foreign banks operating in Japan.

We, the Association, would like to express our appreciation for this opportunity to comment on the consultation paper of the Volcker Rule (*"Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds"* [Docket No. FSOC - 2010 - 0002.]) released on October 6, 2010, by the Financial Stability Oversight Council.

We hope that our comments below will further assist the FSOC in its efforts to formulate the rules.

I. General comments

We understand the need for new regulation in order to limit speculative investments by deposit-taking financial institutions in order to prevent a recurrence of a financial crisis and to protect investors and depositors. On the other hand, banks need access to all forms of financial instruments in order to maintain and facilitate financial intermediary functions in economies inside and outside the region. Extreme restrictions and prohibitions will narrow the range of measures, means and methods available as banks react to changing environments and will also reduce the size of the market itself. The safety and soundness of bank management and even the soundness of society as a whole could conversely be put at risk.

This rule will be introduced in the United States, but given the breadth of its scope, the rule can be expected to significantly impact the earnings and organizational structures of financial institutions. We urge that sufficient consideration be given to the design of systems and practical administration of regulations so that strengthened regulations in the United States do not impair the stability of the entire financial system or undermine the recovery of the global economy.

The rule explicitly includes the trading of government bonds and GSE (Government Sponsored Enterprises) bonds as "permitted activities" for banks, etc., but leaves to yet-to-be-drafted rules the definitions of specific scopes for: 1) transactions related to underwriting- or marketmaking-related activities designed not to exceed the reasonably-expected near-term demands of clients, customers or counterparties; 2) transactions in connection with individual or overall positions, contracts or other holdings with respect to risk-mitigating hedging activities; and 3) purchase, sale, acquisition, or disposition of securities or other instruments on behalf of customers. Should the law be interpreted narrowly in the drafting of relevant rules, the scope of operations permitted to banks could be excessively restricted, which would in turn adversely impact customer convenience, economic growth and the development of financial services. To minimize such damage, we encourage sufficient care to ensure that transactions are not excessively restricted. We encourage the SEC and FRB, etc., as they formulate the specific rules regarding the "permitted activities" of banks stipulated in the Dodd-Frank Act, to minimize adverse impacts on customer convenience, economic growth and the development of financial services by exercising sufficient care to ensure that transactions are not excessively restricted. We request the FSOC to make recommendations from this perspective.

We also think that restrictions and prohibitions would be more appropriately applied on an individual basis rather than across the board, taking account of the individual financial institution's business conditions, size, and risk volume. We believe that it is possible to take steps to encourage and reinforce the safety and soundness of banks so that banks themselves carry more appropriate levels of market, credit and other risks.

II. Specific comments

(1) <u>Factors and considerations to be considered in proprietary trading rules (Q2)</u>

1) Scope of transactions

We hope that a decision is made to allow some exceptions in the prohibition of proprietary trading, based on instrument liquidity, inherent credit risks, relationship with core business and risk management. More specifically, in addition to Treasuries and GSE bonds, we would like the scope of permitted instruments to include eurodollar interest futures, FF interest futures and major currencies. This is because, like Treasuries and GSE bonds, interest futures and major currencies are extremely liquid and have very transparent pricing, and this allows almost immediate identification of the locus of risk. These instruments are also closely related to the core operations of commercial banks and can be subject to appropriate risk controls when necessary.

In conjunction with this, we seek to confirm whether restrictions will apply to World Bank and other international institution bonds, corporate bonds and non-US sovereign bonds.

2) Trading books

Even for locations within the United States, determinations regarding the use of trading and non-trading (banking) books are based upon the governing law of the home country of the bank's head office. We believe the Volcker Rule should respect the spirit of countries’ laws. The definition of trading books subject to regulation under the law should respect the stipulations of the governing law of the home country of the regulated bank's head office.

3) Derivatives

Derivatives and similar instruments mitigate and reduce the risks associated with the underlying assets for the purpose of financial management by corporations and/or financial institutions and will increase in importance as global economic activities become more complex. Excessive restrictions and controls in proprietary trading regulation are likely to adversely affect corporate economic activities because they will narrow the range of discretion open to financial institutions and reduce the size of markets. We therefore urge consideration of a framework that does not extend to transactions with beneficial economic effects.

Derivatives and similar instruments have the beneficial effect of mitigating and reducing the risks associated with assets held by financial institutions and enterprises. We urge that care be taken not to impact transactions that have a beneficial economic effect when considering restrictions on proprietary trading and control frameworks.

(2) Factors and considerations to be considered in the regulation of investments in funds (Q3)

We are aware that certain exceptions are permitted regarding investments in private equity (PE) funds and seek to confirm that this rule does not prohibit all transactions involving banks and PE funds. We seek to confirm that the target of regulation is banks' investments in funds and that regulations do not restrict transactions between banks and enterprises in which funds invest.

With respect to restrictions on investments in funds by bank executives and employees, the rule excludes executives and employees directly providing "Other Services" to the fund from restrictions on investment. We wish to confirm that "Other Services" includes the fund's middle office and back office operations. Investments in the fund by executives and employees involved in the fund's operations will help alleviate conflicts between financial institutions soliciting investors and the investors themselves.

(3) Definitions of activities related to proprietary trading, hedge funds and PE funds (Q4)

1) Hedge funds and PE funds

The rule applies to hedge funds and PE funds, with regulated transactions to be defined by FRB, SEC and CFTC authorities. We express our strong desire for a specific, explicit definition of the categories of funds and types of investments subject to regulation. More specifically, we seek an explicit statement regarding whether regulations apply to fund management companies or to investment instruments and investment methods. Different methods of investing in funds incur different risks, and we recommend that "PE fund" be defined as "a fund that invests only in non-public common stock.” We also seek to confirm our understanding that the scope of "hedge fund" for the purpose of these regulations is limited to investment companies (fund vehicles) that are not registered with the SEC. The index funds offered by hedge fund management companies are generally considered to be low-risk, and we seek to confirm whether they will be subject to regulation.

2) Proprietary trading

The definition of "proprietary trading" contains the wording "any other security or financial Instrument." We seek to confirm that this definition does not apply to loans because loans are part of the core operations of a bank.

3) Illiquid Fund

The detailed, specific definition of "Illiquid Fund" as found in §619 (h) (7) of the Act is unclear. However, when formulating the definition we would, in light of real-world liquidity, encourage consideration of the inclusion of all private equity funds (particularly buyout funds) other than funds that invest only in listed financial instruments (listed equities, etc.).

One example of "illiquid assets" in the definition of "Illiquid Fund" is "portfolio companies." We would like an explicit statement that this refers not only to non-public equity, but also subordinated credits, distressed credits, and other general investment assets for which there are no officially-published disposal prices.

(4) Factors increasing risk volume (Q7)

Proprietary trading and investments in hedge funds, etc., generally focus on highly-liquid financial instruments because they are part of the tools used to improve bank operations and earnings. Changes in the market environment result in increased or decreased market risk, credit risk and liquidity risk of positions held. Some Japanese banks handle securitized instruments similar to those that triggered the financial crisis, but because these instruments were managed—for example, by restricting the scope of instruments handled and establishing trading ceilings—losses were limited at such institutions. Going forward, we believe that these kinds of management approaches will be effective in constricting any amplification of risk of the sorts these transactions involve.

(5) Application of the Volcker Rule to foreign banks (Q10)

When formulating detailed regulations, we seek an explicit statement that the rule does not apply to the operations of non-US banks outside the United States.

The exceptions for extra-territorial application under §619 (d) (4) (I) refers to "the acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a [foreign] banking entity... solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States..." We believe that "solely outside of the United States" must be defined more precisely.

We recommend that the definition of “solely outside of the United States” consider the fund's domicile, the location at which it is managed and the location of its bookings. In other words, we seek an explicit statement that regulations do not apply to foreign funds (including the Cayman Islands), funds managed outside the United States and investments in hedge funds booked outside the United States (for example, in Tokyo for Japanese banks) because these constitute "transactions outside of the United States.”

Under the wording of regulations on investments in funds, the Volcker Rule could apply to a non-US bank that has been licensed under the US Bank Holding Company (BHC) Act investing in a limited partnership (LP) ownership interest in a non-US fund [for example, an LP ownership interest by a Japanese bank in a PE fund organized by a general partner (GP) domiciled in Japan and booked in Japan] if the fund's LP ownership interest is (or in the future will be) sold in the United States.

However, it is not always possible for LP investors to obtain information in advance regarding the participation of US investors in funds in which they invest, and even if such confirmation is made in advance, other investors may sell their LP ownership interest in the United States or other LP investors may be acquired by US enterprises after the investment. An additional problem is the lack of means by which foreign financial institutions investing in PE funds can actively adhere to the Volcker Rule. We ask that these issues be fully considered when formulating detailed regulations and that the exceptions explicitly describe the differences in treatment for GP ownership interest and LP ownership interest.

(6) Divestiture of illiquid assets (Q11)

While the deadline for disposal of illiquid funds is explicitly extended, the rule would still have a significant impact if applied in its current form. We seek a grandfathering clause that would allow continued holding of existing assets under certain conditions and subject to certain limits.