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February 13, 2012

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket No. R-1432 & RIN 7100 AD 82

Mr. John Walsh
Department of the Treasury
Office of the Comptroller of the Currency
250 E Street S.W., Mail Stop 2-3
Washington, DC 20219
Docket ID OCC-2011-14 & RIN 1557-AD44

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
RIN 3064-AD85

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549
File Number S7-41-11 & RIN 3235-AL07

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581
RIN 3038-AD05

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

Ladies and Gentlemen:

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to comment on the Proposed Rulemaking on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, issued by the Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Federal

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[1] Fidelity is one of the world's largest providers of financial services, with assets under administration of nearly $3.4 trillion, including managed assets of over $1.5 trillion. Fidelity provides investment management, retirement planning and many other financial products and services to more than 20 million individuals and institutions. Among these services, Fidelity serves as an investment adviser in connection with managing the assets of mutual funds, investment pools and separate accounts. Investors in these funds, pools and accounts include individuals, 401(k) contributors, pension plan beneficiaries, and state and local government pensions.

Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System,[2] as well as the counterpart proposal issued by the Commodity Futures Trading Commission[3] (collectively, the "Volcker Proposal").

We recognize the challenges faced by the Agencies[4] in formulating the Volcker Proposal as required by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the concerns that Section 619 was intended to address. Fidelity is not a "banking entity" to which Section 619 directly applies. However, implementation of the Volcker Proposal in the form proposed by the Agencies would have a significant impact on our mutual funds, investment pools and separate accounts that we manage for investors (collectively, the "Fidelity Funds and Accounts"), each of which engages in a significant number of transactions with banking entities and their affiliates and subsidiaries (collectively, "Covered Banking Entities"). These transactions include, among other things, the purchase and sale of equity and fixed income securities, derivatives and other financial instruments ("Financial Instruments") from and to Covered Banking Entities as part of their market making or underwriting services.

Congress has recognized the critical role played by Covered Banking Entities in providing capital, finance, and related services to businesses in the United States and, ultimately, to mutual funds and other investors.[5] Section 619 expressly permits activities that are critical to the functioning of U.S. financial markets, such as market making, underwriting, and hedging activities, as well as activities conducted on behalf of customers.[6] The Volcker Proposal includes exemptions to the prohibition on proprietary trading with regard to these activities.[7] However, Fidelity is concerned that the market making and underwriting exemptions are drafted too narrowly and will restrict liquidity and depth in the capital markets in which the Fidelity Funds and Accounts transact every day. We are also concerned that the proposed hedging exemption is drawn so narrowly that hedging transactions that serve to offset a portion of the risk of the original trade, that are done on a portfolio basis, or that cross multiple trading desks or groups within a Covered Banking Entity may not qualify for the exemption. Fidelity presented

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[2] Proposed Rulemaking: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (jointly proposed Nov. 7, 2011) (to be codified at 12 C.F.R. pts. 44, 248, 351 and 255).

[3] CFTC Proposed Rulemaking: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (issued Jan. 11, 2012) (to be codified at 17 C.F.R. pt.75).

[4] The Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission are referred to in this letter collectively as the "Agencies."

[5] *See* 156 CONG. REC. S5902 (daily ed. July 15, 2010) (statement of Sen. Bayh). Senator Bayh sought and received confirmation from Chairman Dodd that the permissible activities under the Volcker Proposal would "allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function. Without flexibility, market makers would not be able to provide liquidity to markets."

[6] *See* Dodd-Frank Act § 619(d), 12 U.S.C. § 1851(d).

[7] Volcker Proposal §§ _.4(b), _.4(a), _.5, _.6(a) _.6(b) _.6(c) and _.6(d), respectively.

our concerns regarding the Volcker Proposal at a recent Congressional hearing,[8] where Alexander Marx, Head of Global Bond Trading for Fidelity, described some of the unintended consequences that the Volcker Proposal in its current form would have on certain market making and underwriting activities. His written testimony is attached as an addendum to this letter.

The Fidelity Funds and Accounts rely on the ability of Covered Banking Entities to trade both fixed income and equity securities on a principal basis using generally available hedges to bridge gaps in price and/or time that occur until other market participants may be willing to assume the risks from the Covered Banking Entity in multiple trades. It is crucial for the Fidelity Funds and Accounts that Covered Banking Entities have the ability to make markets and hedge, without undue restriction. On behalf of the shareholders and clients in the Fidelity Funds and Accounts, we request that the Volcker Proposal be revised to provide the broadest exemptions possible under the statute for market making, underwriting and hedging activities.

Covered Banking Entities Perform Essential Functions for Fidelity Funds and Accounts

On each day markets are open, the Fidelity Funds and Accounts engage in trades totaling billions of dollars with Covered Banking Entities. In the primary market for fixed income Financial Instruments, which is an over-the-counter ("OTC") market, Covered Banking Entities serve as underwriters by purchasing bonds and money market instruments from corporate and municipal issuers and, in turn, selling those Financial Instruments to a wide range of investors, including the Fidelity Funds and Accounts. This is an essential function for the Fidelity Funds and Accounts, as the Covered Banking Entities facilitate the creation of new securities for the Fidelity Funds and Accounts to invest in by purchasing securities of issuers, an essential role in capital formation.

In the secondary market, the Fidelity Funds and Accounts rely on a Covered Banking Entity's ability, at any particular time, to buy and sell Financial Instruments. This is also a vital market function as the Fidelity Funds and Accounts can trade Financial Instruments with Covered Banking Entities without spending time and money to find another investor in the market who is a perfect match for a particular trade. Many of these trades simply would not occur if Covered Banking Entities were not able to commit capital to purchase securities and hold Financial Instruments until another buyer is located. This ability allows the Covered Banking Entity to serve as a direct counterparty to each Fidelity Fund or Account, thereby facilitating the Fidelity Fund or Account's day-to-day trading needs.

In these transactions, the Covered Banking Entity is not trading solely on behalf of a third-party client (a process known as trading on an "agency" basis), but rather on a customer-facing principal basis. We believe that this type of principal trading is distinguishable from speculative proprietary trading. In customer-facing principal trading, the dealer is making a market in securities, which allows the Fidelity Funds and Accounts to transact efficiently.

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[8] Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation: Joint Hearing Before the H. Comm. on Financial Services, 112th Cong. (2012), available at http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=274322.

Principal trading is commonplace in fixed income markets. In the equity markets, although a significant portion of trading is done on an agency basis, larger investors, such as the Fidelity Funds and Accounts, also engage in a considerable amount of trading with Covered Banking Entities on a principal basis to reduce transaction costs and to mitigate shareholder risk.

Block trading represents one important example of how both equities and fixed income securities are traded by Fidelity Funds and Accounts with Covered Banking Entities on a principal basis. Block trading relies heavily on Covered Banking Entities' ability to act as market makers undertaking principal risk because, generally, an investor selling securities requires a Covered Banking Entity acting as a dealer to guarantee a minimum price or volume for the block trade. This principal trading by Covered Banking Entities benefits investors by facilitating trading at a more favorable execution price in a single transaction, rather than requiring trade execution in smaller increments over a longer period of time. We are concerned that the Volcker Proposal in its current form will unnecessarily impair the ability of Covered Banking Entities to facilitate block trading, because they may not be able to qualify for the market making exemption when entering into block trades. We encourage the Agencies to recognize the legitimate investment and trading needs of investors like the Fidelity Funds and Accounts by explicitly recognizing that customer-facing principal trades and block trades qualify for the market making exemption.

Volcker Proposal's Impact on Key Financial Products

In addition to the overarching impact on the liquidity of the financial markets, we are concerned that the Volcker Proposal will have harmful effects, without commensurate benefits, on certain instruments that are critical to the Fidelity Funds and Accounts.

A. The Definition of "Municipal Securities" Should be Expanded

The Volcker Rule provisions in the Dodd-Frank Act contemplate that the Agencies will exclude certain types of securities from the general prohibition on proprietary trading, including securities issued by the federal government, states and political subdivisions of states. We believe that the drafters of the Dodd-Frank Act correctly recognized that government securities should be beyond the scope of the proprietary trading prohibition for a variety of reasons. Municipal securities, for example, are the primary source for financing important governmental, municipal and non-profit community projects. The Fidelity Funds and Accounts hold over $90 billion of municipal securities.

As currently drafted, however, the Volcker Proposal does not include securities issued by state agencies or instrumentalities in its exemption for municipal securities.[9] These securities represent approximately half of the securities offered by issuers in the municipal market.[10]

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[9] Volcker Proposal §_.6(a); n. 165.

[10] *US Municipal Strategy Special Focus*, Citigroup Global Markets Research Report, Nov. 20, 2011, *available at* http://www.nabl.org/uploads/cms/documents/Volcker_Muni_Proposal.pdf.

Failing to include such municipal securities in the statutory exemptions will increase the trading costs to shareholders and clients in the Fidelity Funds and Accounts.

We believe that in this context the distinction between securities issued by states and their political subdivisions, on the one hand, and securities issued by state agencies or other instrumentalities, on the other hand, is without basis. This approach would lead to a bifurcated municipal securities market in which tax-exempt organizations would have to pay higher costs to raise capital. In addition, splitting the municipal securities definition would reduce the liquidity of the municipal securities market as a whole. The Fidelity Funds and Accounts hold a variety of municipal securities: some would be covered by the current version of the municipal securities exemption, and others would not. This unnecessarily limited exemption would significantly increase the trading costs of managing a municipal fund, leading to lower returns for its investors. Furthermore, some states, but not all, have established agencies as political subdivisions; this would mean that the application of the Volcker Proposal's definition of "municipal securities" would have inconsistent application across different states.

Accordingly, we request that the Agencies broaden the scope of the government obligations exemption by revising the definition of "municipal securities" in the Volcker Proposal to cross-reference that term as it is defined in Section 3(a)(29) of the Securities Exchange Act of 1934.[11] The definition of the term in that section properly includes state agencies and instrumentalities, as well as states and their political subdivisions.

B. Covered Funds: Asset-Backed Commercial Paper and Tender Option Bonds

In addition to the restrictions on proprietary trading, Section 619 of the Dodd-Frank Act limits the ability of a Covered Banking Entity to own or sponsor a hedge fund or private equity fund.[12] The Volcker Proposal utilizes the term "covered fund", which is defined to include any "issuer that would be an investment company, as defined in the Investment Company Act of 1940 . . . *but for* section 3(c)(1) or 3(c)(7) of that Act."[13] This definition sweeps in not just private equity funds and hedge funds, but any other financing vehicle that meets the criteria for one of these sections.[14] These other vehicles include structures used in asset-backed commercial paper ("ABCP") and tender option bond ("TOB") programs. The result is that Covered Banking Entities would be prohibited from owning or sponsoring these financing structures. Fidelity Funds and Accounts owned $8.4 billion of ABCP and $12.3 billion of TOB securities, as of January 31, 2012.

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[11] The Securities and Exchange Act of 1934, §3(a)(29), 15 U.S.C. § 78c (a)(29).

[12] *See* Dodd-Frank Act § 619(a)(1)(B), 12 U. S.C. § 1851(a)(1)(B).

[13] Volcker Proposal §_.10(b)(1); *see also* Investment Company Act of 1940, 15 U.S.C. §§ 80a-3(c)(1) and (7) (exempting certain funds that are not offered publicly from registration requirements that govern other investment companies). The Investment Company Act of 1940 is referred to in this letter as the "Investment Company Act."

[14] Id.

Section 619 provides the Agencies with the flexibility to define private equity fund and hedge fund appropriately,[15] as acknowledged by the Agencies in the Volcker Proposal.[16] Simply because other investment vehicles, particularly those involved in structured finance, may also rely on Section 3(c)(1) or 3(c)(7) to avoid being classified as an investment company, does not mean that such vehicles have the same attributes or raise the same concerns that Congress was attempting to address by restricting the ability of Covered Banking Entities from owning or sponsoring hedge funds or private equity funds. Fidelity urges the Agencies to use the discretion granted to them by Congress under Section 619 to exempt ABCP and TOB structures from the definition of "covered fund."

(1) Tender Option Bonds

TOB trusts are funding vehicles that were developed to finance municipal securities for which traditional taxable financing structures are not a viable option. The TOB structure allows issuers to secure stable funding at short-term rates. The sponsor of a TOB structure purchases high quality municipal bonds in the primary or secondary market and transfers those bonds into a trust. Typically, the trust issues two classes of certificates: floating rate certificates and residual certificates. The floating rate investors are generally interested in short-term, tax-exempt investments, and they provide a principal investment equal to 99% or more of the price of the underlying bonds. The investors in the residual certificates are generally Covered Banking Entity sponsors or third party investors, which provide the balance of the capital. The floating rate certificate holder receives a short-term rate of interest that is reset at specified intervals. The holder has the right to sell (i.e., tender) its certificates back to the bank sponsor, and such right is backed by a liquidity provider. The residual holder receives the coupon on the underlying bonds, less the sum of (1) interest paid to the floating rate certificate investors and (2) fees paid to the bank sponsor and trustee. The liquidity provider supports the tender, allowing the holder of the floating rate certificate to receive face value of the security plus accrued interest, either from remarketing proceeds or a draw on the liquidity facility.

TOB trusts hold highly-rated municipal securities, and do not present the types of risk that Section 619 was intended to address. Under the Volcker Proposal, a TOB trust would be deemed a "covered fund" by cross-reference to the Investment Company Act provisions and, accordingly, a Covered Banking Entity would be prevented from sponsoring it or investing in it. This could result in the elimination of TOB trusts entirely, which would remove an important source of short-term investments for investors, including the Fidelity Funds and Accounts. It also would reduce overall demand for municipal securities and have a detrimental impact on the states and municipalities that rely on municipal securities as a critical source of financing. The

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[15] *See* Dodd-Frank Act § 619(h)(2), 12 U.S.C. § 1851(h)(2) ("[t]he terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 [citation omitted], but for section 3(c)(1) or 3(c)(7) of that Act, ***or*** such similar funds as the [Agencies] may, by rule, as provided in subsection (b)(2), determine" (emphasis added).

[16] *See* Volcker Proposal, Question 221, in which the Agencies query whether the "covered fund" definition should "focus on the characteristics of an entity rather than whether it would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act."

Volcker Proposal should expressly state that TOB structures will be excluded from the definition of "covered fund" and that TOBs are exempted from the proprietary trading prohibition.

(2) Asset-Backed Commercial Paper

ABCP programs are senior-secured working capital financing vehicles that issue instruments in the money markets. Manufacturers, banks, finance companies, and broker-dealers all use ABCP programs to obtain low-cost financing for a diverse range of trade and financial receivables, including manufacturing account receivables, commercial loans, equipment loan and lease receivables, consumer loans, auto loans and leases and student loans. Historically, ABCP has been an important investment for money market mutual funds, including those managed by Fidelity. The sponsorship of ABCP programs is part of traditional banking activities and not comparable to hedge fund or private equity fund activities, which are the focus of Section 619.

Generally, a Covered Banking Entity will be involved in the creation of an ABCP program, which could be interpreted to be a "covered fund" under the Volcker Proposal since it relies on the same statutory exemptions from investment company status. The sponsoring Covered Banking Entity will typically provide critical support facilities to the ABCP program. These support facilities – a traditional banking function – serve to enhance the liquidity and credit profile of the issued debt instruments. Any application of the Volcker Proposal to ABCP would be inappropriate and, accordingly, we believe the Volcker Proposal should be revised to expressly exclude ABCP programs and to exempt the related securities from the proprietary trading prohibition.

(3) Additional Impact on ABCP and TOB Programs

In addition to the foregoing, another complication would arise if ABCP or TOB structures were considered to be "covered funds." Specifically, subject to limited exceptions, newly codified Section 13(f) of the Bank Holding Company Act prohibits all "covered transactions"[17] between a Covered Banking Entity and any covered fund it sponsors or manages. This means that if ABCP and TOB structures are not carved out of the definition of "covered fund," a sponsoring Covered Banking Entity would be prohibited from providing a liquidity facility to support the ABCP or TOB program under the Volcker Proposal.[18] Eliminating the liquidity facility from the standard structure for ABCP and TOB programs would jeopardize the low risk nature of investments in such programs, which would ultimately harm shareholders and clients of the Fidelity Funds and Accounts. We do not believe this issue needs to be addressed if the Agencies properly exempt ABCP and TOB programs from the definition of "covered fund" in the Volcker Proposal. However, if the Agencies do not revise the Volcker Proposal in that manner, they should expressly (i) include ABCP and TOB structures within the loan securitization exemption and (ii) permit the liquidity support and credit enhancement for such programs to be provided by Covered Banking Entities.

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[17] *See* 12 U.S.C. 371c (defining "covered transactions").

[18] Volcker Proposal §_.16(a)(1). *See also* Dodd-Frank Act § 619(f), 12 U.S.C § 1851(f).

C. OTC Derivatives

The Fidelity Funds and Accounts use derivatives to take market risk, diversify risk exposure, or to gain or hedge against risks related to particular investments, issuers or sectors. Shareholders and clients in Fidelity Funds and Accounts benefit from the ability of our portfolio managers to use derivatives in these ways, consistent with the relevant investment strategy.

The counterparties to the Fidelity Funds and Accounts for OTC derivatives trades are generally Covered Banking Entities. Currently, Covered Banking Entities typically manage ongoing residual risks on a portfolio basis, often looking at the OTC derivatives business as part of their overall equity or fixed income businesses.

The supplementary information included with the Volcker Proposal recognizes that dealers do not make markets in OTC derivatives in the same way that brokers make markets in securities. Notwithstanding this difference, market making is essential to well functioning OTC derivatives markets. The current version of the Volcker Proposal's market making exemption does not adequately reflect the unique nature of the OTC derivatives market. We believe the effect is that Covered Banking Entity trading in OTC derivatives would be unnecessarily limited, which would result in reduced liquidity and increased volatility in the OTC derivatives market and the diminished ability for market participants to manage and take market risk. Accordingly, the Fidelity Funds and Accounts would have less access to these Financial Instruments. We urge the Agencies to revise the exemption to allow appropriate market making activities in the OTC derivatives market to be performed by Covered Banking Entities.

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We appreciate the opportunity to comment on the Volcker Proposal. Fidelity would be pleased to provide any further information or respond to any questions that the Agencies' staff may have.

Sincerely,

cc:
Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation
Gary Gensler, Chairman, Commodity Futures Trading Commission
Timothy F. Geithner, Secretary of the Treasury
Mary L. Schapiro, Chairman, Securities and Exchange Commission

Testimony of

Alexander Marx

Head of Global Bond Trading

Fidelity Investments

Before the
Financial Services Subcommittee on Financial Institutions and Consumer Credit
and the
Financial Services Subcommittee on
Capital Markets and Government Sponsored Enterprises

January 18, 2012

Chairmen Capito and Garrett, Ranking Members Maloney and Waters, and Members of the Subcommittees, thank you for the opportunity to testify today on the proposed restrictions on banking entities engaging in proprietary trading and from having certain relationships with hedge funds and private equity funds, more commonly known as the "Volcker Rule." My name is Alex Marx and I am the Head of Global Bond Trading for Fidelity Investments. In this role, I am responsible for the bond trading that supports the broad array of investment products for which Fidelity serves as investment adviser, including the Fidelity mutual funds.

Founded in 1946, Fidelity Investments is one of the world's largest providers of financial services, with assets under administration of $3.4 trillion, including managed assets of more than $1.5 trillion, as of December 31, 2011. The firm is a leading provider of investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 20 million individuals and institutions, as well as through 5,000 financial intermediary firms.

Fidelity Investments is a market leader in asset management, offering over 400 mutual funds across a wide range of disciplines, including equity, investment grade bond, high income bond, asset allocation, and money market funds. In addition, Fidelity Investments offers comprehensive investment management solutions for institutional investors, such as defined benefit and defined contribution plans, insurance accounts, endowments and foundations. Fidelity is also a leading provider of asset allocation solutions for retail and institutional clients.

The assets that Fidelity manages across this comprehensive product offering belong not to Fidelity, but to the funds and the millions of shareholders and customers who have entrusted their savings with us. Fidelity's asset management offerings pool the investments of many individuals. Fidelity, in turn, then interacts and negotiates with Wall Street banks on behalf of these investors through our management of the funds. In carrying out these responsibilities, Fidelity has a fiduciary duty to serve in the best interest of the shareholders of the funds it manages.

These shareholders seek the benefits that come from investing in a diversified pool of securities under the direction of an experienced staff of investment professionals. This staff includes seasoned portfolio managers working closely with Fidelity's dedicated team of research staff to analyze and evaluate possible investments and with Fidelity's trading team, located around the globe, that executes their investment decisions. These trading operations span the full range of investment disciplines that Fidelity offers, including equity, bond and money market trading desks.

The Volcker Rule does not apply to Fidelity directly; however, implementation of the rule, in the form proposed by the agencies in October, may have a significant indirect impact on our ability to manage our shareholders' funds and execute trades on their behalf. As Fidelity considers the impact of the proposed rule, we are mindful of the following concepts:

- Funds, including those managed by Fidelity, collectively represent a significant portion of the investments made by the American public. These funds rely on the liquidity provided by banks and their affiliates as market makers.
- Restrictions on the ability of banks and bank affiliates to provide crucial market making services to investors and to provide underwriting services to issuers of corporate and municipal securities should not jeopardize traditional sources of capital for issuers, investments for issuers, or liquidity for the market generally. Market illiquidity will result in price uncertainty, volatility, higher transaction costs and a reduced ability to access capital.
- The ultimate macro-economic effects of undue restrictions on banks and their affiliates would be to constrict significantly the ability to raise capital, to weaken U.S. job growth, to prevent U.S. financial institutions from competing with their foreign counterparts, and to erode the value of investment and retirement portfolios of American households.

The members of Fidelity's trading team, when executing the trades for the funds Fidelity manages, interact on a daily basis with banks and bank affiliates to whom the restrictions in the Volcker Rule will apply. Currently, these bank entities buy equity and fixed income securities from, and sell them to, our funds in their role as dealers. The bank entities form a significant portion of the dealer community and are essential to the efficient operation of the securities markets.

Dealers Perform an Essential Function in the Capital Markets

Dealers play an integral role in the markets. For example, in the primary market for fixed income funds, which is an over-the-counter market, dealers purchase bonds and money market instruments from corporate and municipal issuers and, in turn, sell these securities to investors, such as Fidelity's funds. In these transactions, dealers serve as underwriters to the issuers and then to the trading counterparties to our funds. In doing so, dealers help establish the initial price for the securities and oversee the distribution of the securities to investors. In the secondary market, dealers perform an equally critical role by purchasing securities from investors who desire to sell them, and then selling those securities to other interested buyers.

This intermediary function of connecting buyers and sellers of securities is an important component of the efficient operation of the capital markets. Fidelity's funds rely on the fact that a dealer will be able, at any particular time, to provide an ample source of liquidity for the funds when they would like to purchase particular securities. Similarly, a dealer can purchase securities from Fidelity's funds upon request because the dealer can hold the securities in its inventory until it finds a purchaser for those securities.

In this manner, the process by which a fund buys or sells securities does not require the fund to find another investor in the market who is a perfect match for that particular trade. Rather, a dealer's ability to hold inventory on its books allows it to be a direct counterparty to the funds, thereby facilitating the funds' day-to-day trading needs. In this capacity, the dealer is not trading solely on behalf of a third-party client in its transactions with the funds (a process known as trading on an "agency" basis), but instead on a principal basis. This type of principal trading differs from speculative proprietary trading. In customer-facing principal trading, the dealer is making a market in securities, which allows customers, such as the Fidelity mutual funds, to transact efficiently. There is risk and reward involved in this trading for the dealer – as the price of the security may decline or increase in the time between the purchase from one customer and the sale to another. This type of trading also requires the dealers to commit a certain amount of capital to make securities trades.

If the ability of banks to engage in principal-based trading were hampered, there would be a significant risk that the difference between the price that a buyer is willing to pay for a security, compared with the price for which a seller is willing to sell it (known as a "bid-ask spread"), would increase dramatically. A wide bid-ask spread is a sign of market inefficiency: in the primary market, issuers would have to pay higher rates to raise capital, while in the secondary market, investors would need to pay a market premium in order to purchase desired securities and absorb a market discount in order to sell securities. In addition, this lack of predictable and fluid market dynamics creates an environment that is ripe for significant market volatility. Wider bid-ask spreads, a reduction in market liquidity and an increase in market volatility could severely damage the funds' ability to trade in the markets on behalf of their investors.

The Volcker Proposal Has Unintended Consequences and Would Harm the Economy

The Volcker Rule provisions in the Dodd-Frank Act generally prohibit banks and their affiliates from engaging in proprietary trading, but also expressly permit banks and their affiliates to engage in activities that are critical to the functioning of the U.S. financial markets, including market making and underwriting activities. These activities are part of the customer-facing principal trading on which our funds rely. By creating these categories of permissible activities, Congress recognized the critical role that banks and their affiliates play in providing such services to U.S. businesses and to individual investors, many of whom utilize mutual funds and other investment vehicles as their primary means of investing.

The Volcker Rule regulations, in the form proposed by the agencies in October (the "Volcker Proposal"), acknowledges the permissible activities set forth in the Dodd-Frank Act by including exemptions for each of these activities, including market making, underwriting, and hedging. Fidelity is concerned, however, that these exemptions are too narrowly crafted, include too many conditions to be workable in practice and rest on the presumption that critical market practices that occur today should be prohibited unless the onerous criteria are met. We believe these factors would combine to have a chilling effect on capital formation and market liquidity and, in turn, will negatively impact individuals seeking to invest their savings (including the shareholders of the funds we manage) and businesses accessing the capital markets to help grow their operations.

A. The Volcker Proposal Would Reduce Market Liquidity

Banks and their affiliates provide critical liquidity to financial markets. Liquidity is a measure of how easily an asset can be bought or sold with minimal impact to its value. If a market is highly liquid, investors have the ability to buy or sell assets quickly and easily at prices that appropriately reflect their true value, as the assets are regularly traded and there are sufficient numbers of willing buyers and sellers. A closely related concept is the “depth” of a market. If a market is deep, investors can trade large volumes without substantially affecting the price of an asset.

We believe that the Volcker Proposal presents risks to market liquidity. The proposal would restrict the ability of banks and their affiliates to hold an adequate inventory of securities. Under the current regulatory landscape, banks and their affiliates are able to make available for sale to investors securities with a wide array of characteristics (such as varying maturities, issuer profiles, and levels of creditworthiness) that allow investors to manage their portfolios efficiently. In order to comply with the Volcker Proposal in its current form, a bank would be more likely, at any point in time, to have less inventory on its books that includes the particular securities that investors desire. This is because the exemptions to the prohibition on proprietary trading (chiefly the exemption for market making-related activities, underwriting and hedging) are drafted narrowly and are likely to cause untenable hurdles that banks are unlikely to overcome.

There are at least three potential negative outcomes arising from this reduced liquidity:

- Business growth and activity will be hampered as the result of companies and municipalities having less efficient access to capital, with resulting deleterious effects on employment and the economy.
- Security transactions will be more challenging to carry out and there will be negative effects on the investment performance of the funds that individual investors, pension plans, and other institutional investors hold.

- A less predictable flow of purchases and sales of securities, caused by the foregoing factors, will result in price uncertainty and higher volatility, which would ultimately damage issuers and investors alike.

1. The Market Making Exemption is Too Narrow and the Uncertainty around Its Application Would Negatively Impact Shareholders

Under the Volcker Proposal, banks and their affiliates generally would have to satisfy seven criteria in order to rely on the market making exemption. However, because certain markets, such as certain asset classes within the fixed income market, are complex and less liquid than others, the strict requirements may have the unintended consequence of further limiting liquidity in the markets. For example, the typical role of market maker banks in over-the-counter markets, including fixed income markets, is to bridge the gap between buyers and sellers and to provide the liquidity necessary for these markets to function. This results in the ability for mutual funds to be more fully invested in the capital markets. However, based on the criteria for the market making exemption under the Volcker Proposal, this activity would not qualify as market making.

Significant uncertainty about the application of the market making provisions in the Volcker Proposal would be detrimental to the financial markets and would negatively impact fund shareholders. Uncertainty about the ability of a bank to transact would increase the risk of purchasing securities and would be reflected in higher funding costs. Importantly, because of the nature of the risks presented and the lack of liquidity, there would be no net benefit to investors.

2. Fidelity Has Similar Concerns with the Underwriting Exemption

The Volcker Proposal permits a bank to purchase or sell securities in connection with the bank's underwriting activities if the activities satisfy certain criteria. The transaction must be effected solely in connection with a distribution of securities for which the bank is acting as an underwriter and the bank's underwriting activities with respect to the security must be designed not to exceed the reasonably expected near-term demands of clients. This ignores the basic risk-taking function of underwriting. The primary reason for an issuer to engage an underwriter is to transfer the risk of selling the securities from the issuer to a single dealer (or small group of dealers). To perform this function, dealers at times need to commit their own capital to purchasing the securities from the issuer. If the dealer is successful in marketing the securities to clients, then the dealer will not have any securities left in inventory. If the dealer is not successful, then the firm will have securities left on its books until they are able to sell all of them to customers.

In its current form, the conditions that the regulators have proposed in connection with underwriting would make it untenable for banks and their affiliates to purchase securities for their own account should investor demand fall short of expectations. Because banks likely would be unwilling to assume this risk, higher rates would be required to lure investors, causing the cost to businesses of raising capital to increase. Thus, the Volcker Proposal has the potential to rearrange current market practice in underwriting to the detriment of both issuers and underwriters. This likely would result in a more concentrated supply of securities, thereby decreasing the opportunity for diversification in the portfolios of shareholders' funds.

B. Both the Equity and Fixed Income Markets Would Be Affected by the Volcker Proposal

While much of the focus surrounding the proposed regulations is on fixed income markets, it is important to note that the Volcker Proposal is also a significant issue for investors in equity markets. Block trading is an important investment strategy used by mutual funds and other investment funds, in both equity and fixed income markets. Block trades refer to transactions in which a significant amount of shares of stock or bonds are traded with a bank at one time. Large block trades can be structured in several ways, but generally speaking, sellers require banks acting as dealers to guarantee a minimum price or volume for the block trade. As a result, block trading relies heavily on banks acting as market makers undertaking principal risk.

Contrary to some misperceptions, equity trading is not conducted exclusively on an agency basis. A significant portion of equity trading is often done on a principal basis. While retail investors often trade under an agency-based "last sale" model (in which transaction prices would represent the scrolling tickers common on financial news televisions networks), larger investors, such as mutual funds, trade in myriad ways with market making activities, such as block trades, conducted by banks in efforts to reduce transaction execution costs, mitigate shareholder risk, and, ultimately improve shareholder returns.

Fidelity achieves these goals for its funds by trading with market makers that use generally available hedges to bridge the gap in terms of price and/or time where different types of investors are willing to assume the risks. Banks also conduct program risk trading, which enables fund advisers to swiftly and efficiently trade multiple securities in a single transaction and manage significant flows into and out of funds in a cost-effective manner. Fidelity believes that the Volcker Proposal must take a broad enough view of what constitutes a "trading unit," which is also commonly referred to as an "aggregation unit," to permit banks to adequately aggregate their positions for purposes of hedging their trades with institutional clients and to avoid a reduction in market liquidity. It is crucial for fund advisers to have access to banks' traditional equity securities market making activities, including their ability to enter into block trades and to hedge without undue restriction, so that shareholders will not be faced with unnecessarily increased costs and risks. It is not likely, however, that such activities would qualify for an exemption under the Volcker Proposal in its current form.

C. The Volcker Proposal's Impact on Key Financial Products Would be Harmful to Fund Shareholders

In addition to the overarching impact on the financial markets, we are concerned that the Volcker Proposal will have harmful effects, without the corresponding benefits, on certain instruments that are critical to the U.S. economy and financial markets, and as a result will be disadvantageous to investors in our funds.

The Volcker Rule provisions in the Dodd-Frank Act (Section 619) contemplate that the agencies will exclude certain types of securities from the general prohibition on proprietary trading by banking entities, including securities issued by the federal government, states and political subdivisions of states. We believe that the drafters of the Dodd-Frank Act correctly recognized that government securities should be beyond the scope of the proprietary trading prohibition for a variety of reasons.

As currently drafted, however, the Volcker Proposal does not include securities issued by state agencies or instrumentalities within its exemption for municipal securities.

The result is that, with respect to a significant number of the securities offered by issuers in the municipal market, the exemption from the proprietary trading prohibition would not apply. We believe that the distinction between securities issued by states and their political subdivisions, on the one hand, and securities issued by state agencies or other instrumentalities, on the other hand, is without basis and would lead to a bifurcated municipal securities market in which the ability of tax-exempt organizations to raise capital would be unreasonably hampered. It would also be likely to have a negative effect on the liquidity of the municipal securities market as a whole. Accordingly, we believe that the agencies should revise the definition of "municipal securities" in the Volcker Proposal to cross-reference that term as it is already defined in Section 3(a)(29) of the Securities Exchange Act of 1934. The definition of the term in that section properly includes state agencies and instrumentalities, as well as states and their political subdivisions. This revision to the Volcker Proposal would be within the spirit of Section 619 of the Dodd-Frank Act and would prevent unreasonable impairment of the municipal securities market.

Section 619 of the Dodd-Frank Act also states that a banking entity, in addition to being subject to the general prohibition on proprietary trading, cannot own or sponsor a hedge fund or private equity fund. The agencies have significantly expanded upon this basic prohibition by utilizing the term "covered fund" in the Volcker Proposal, which they have defined to include not only hedge funds and private equity funds as contemplated by the Dodd-Frank Act, but also other structures that are not considered investment companies under the Investment Company Act of 1940. The result is that the proposed regulation casts a very broad net, capturing certain other widely accepted financing structures that rely on these exemptions. There are few similarities between the hedge funds and private equity funds that were the target of the Dodd-Frank Act and these other types of structures. Accordingly, we do not agree with the Volcker Proposal's treatment of these entities in the same manner.

Two examples of structures that would likely fall under the "covered fund" prohibition, by default, are asset-backed commercial paper programs and tender option bond programs. These types of structures provide a critical source of financing for corporations and municipalities by providing short-term and long-term financing needs. Additionally, these programs enable investors, such as Fidelity's funds, to access an important supply of securities. We believe the problem presented by the current version of the Volcker Proposal can be solved by appropriately tailoring the definition of a "covered fund" and coupling it with stringent anti-avoidance rules. This would satisfy the statutory intent of Section 619 of the Dodd-Frank Act regarding hedge funds and private equity funds, while allowing other types of financing structures to continue to be available in the market.

D. The Proposed Volcker Rule Would Have a Negative Effect on the U.S. Economy and U.S. Competitiveness

An economy is considered healthy when it has high employment levels, stable prices and sustained growth. Capital markets directly impact each of these objectives by providing the means for the development of and investment in businesses. Any changes in the availability and cost of funds in capital markets affect the overall economy. Excessive constraints upon market making, underwriting and hedging activities will cause an increase in the cost of funding in affected markets. When businesses face higher funding costs, they typically respond by constricting their plans for growth, which also has a direct effect on their role as employers.

Banks and their affiliates provide a number of unique services that are vital to economic development and that historically have kept capital costs low for borrowers. Foremost, banks serve as intermediaries to match investors who have capital with borrowers who seek it. Borrowers use such capital to grow and expand their businesses, in turn creating jobs that create critical stimulation for the U.S. economy.

Given the role that banks and their affiliates play in the financial markets, it is important to consider the negative impact that the Volcker Proposal could have on the banks' ability to compete in the global market to provide financial services. Because other countries have not proposed equivalent limitations on market making, underwriting, and hedging activities, we foresee certain potential negative outcomes that would be caused by the Volcker Proposal. U.S. banks will become less competitive than their foreign counterparts as they contribute less liquidity in the global marketplace and are forced to devote significant resources in their efforts to comply with the Volcker Proposal. Alternatively, foreign banks with U.S. operations may be forced to relocate their operations overseas to avoid the overly burdensome restrictions under the rule. This would deprive U.S. issuers of the underwriting services of such foreign banks and would deprive U.S. investors of a critical source of market making. In each case the potential impact on the U.S. economy as a whole could be significant.

Conclusion

Fidelity is concerned about the impact that the Volcker Proposal, if adopted in its current form, would have on market making, risk management, underwriting and other crucial activities carried out by banks and their affiliates that serve as dealers. We believe that, unless properly tailored, the proposal will impede the U.S. economic recovery. Strong capital markets are critical to restoring a robust economy. If the Volcker Proposal is implemented in an unduly restrictive manner, the result would be to adversely impact the ability of markets to function efficiently, thereby hindering investors' efforts to preserve and increase their assets.

These consequences are avoidable. Congress specifically exempted market making-related, underwriting, and risk-mitigating hedging activities from the Volcker Rule. While we recognize the difficulties faced by the regulators in ensuring these exemptions do not undermine the general prohibition on proprietary trading, we believe the Volcker Rule need not be implemented in a way that impedes these crucial activities.

We plan to submit comments to the agencies on the Volcker Proposal and we look forward to working with Congress and the regulators to ensure that any final rulemaking is appropriately tailored and will not create negative unintended consequences for investors, capital formation, and economic growth.

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We appreciate the Subcommittees' focus on the issues presented by the Volcker Proposal and for the opportunity to testify today.