Statement of BlackRock, Inc.

Joint Hearing on Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation

The Capital Markets and Government Sponsored Enterprises Subcommittee and the Financial Institutions and Consumer Credit Subcommittee

House Financial Services Committee
January 18, 2012

BlackRock, Inc. appreciates the opportunity to provide the Committee with its comments regarding the Volcker Rule and the potential impact of the pending rule proposal[1] on the U.S. capital markets.

BlackRock is one of the world's leading asset management firms, managing over $3.3 trillion on behalf of institutional and individual clients worldwide through a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. Our client base includes corporate, public, multi-employer pension plans, insurance companies, third-party mutual funds, endowments, foundations, charities, corporations, official institutions, banks, and individuals around the world.

BlackRock supports the policy behind the statutory provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that are commonly referred to as the Volcker Rule – restricting certain proprietary trading and investing activities by banking institutions that are eligible to receive government support. However, as a fiduciary for our clients and a major participant in global markets, we are concerned that the Proposed Rule as drafted will lead to a

[1] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationship with, Hedge Funds and Private Equity Funds (proposed Oct. 11 and 12, 2011 and January 11, 2012) (the "Proposed Rule"")

significant number of adverse impacts and unintended consequences that should be resolved in the final rule.

Impact of the Volcker Rule on Financial Markets

We have significant concerns that the impact of the Proposed Rule on the market making activities of banking entities will have unintended and undesirable consequences for financial markets in general. These consequences will include negative impacts on the performance of investor portfolios. The Volcker Rule specifically carves out market making and customer facilitation activities from the proprietary trading ban. It is critical that the implementation of these exclusions provide a clear framework for these activities to continue without creating regulatory risk and uncertainty for U.S. banks.

BlackRock believes the Proposed Rule creates significant uncertainties for market makers which will disrupt the markets for certain securities. The uncertainties are particularly acute for fixed income securities, where the ability of dealers to hold inventory and commit capital are critical to the efficient operation of the market. A disruption in dealer activities will lead to less liquidity in the market, resulting in wider bid-ask spreads and higher borrowing costs, which will have significant negative economic consequences for savers as well as for corporate and municipal borrowers.

While we appreciate that the Volcker Rule requires the regulatory agencies charged with its implementation to delineate activities that are considered proprietary trading from those that are market making and facilitating client activities, we believe the rule as proposed creates uncertainty for brokers and an overly complex compliance regime. The result of both these factors likely will be decreased liquidity, especially for credit and securitized fixed income

instruments. We note that liquidity in investment grade securities has already been reduced as primary dealer balance sheets have contracted. In addition to the general reduction in liquidity, normal seasonality periods will further hamper liquidity, creating periods when it may become difficult to cost effectively execute transactions in certain securities.

Investment decisions are heavily dependent on a liquidity factor input – investment strategies and decisions require that not only the initial procurement of the securities is considered, but that there also needs to be a degree of confidence that the securities can be sold in a timely, cost-effective manner. Otherwise, those securities will appeal only to a very limited number of investors and strategies. This is particularly true for strategies that are actively managed, as compared to "buy and hold" portfolios. Regarding "buy and hold" strategies, it should be noted that fixed income portfolios, which are often thought of as "buy and hold" portfolios, are not without relevant risks and require comprehensive risk management, which may include selling selected securities based on a change of credit outlook. Credit risks as well as interest rate risk are both very real and can greatly affect the performance of a fixed income portfolio. As liquidity dissipates, investment strategies become more limited, and returns to investors are reduced by wider spreads and higher transaction costs. Diminished returns impact the ability of investors, such as pension funds, to meet their obligations to their participants and beneficiaries, and also negatively impact savers.

Reduced liquidity will also impact issuers of fixed income securities. We can expect that new issue concessions will increase as liquidity diminishes, as brokers manage the risk of decreased liquidity and the ability to comply with the new rules. We expect that all issuers will be impacted to some degree, including both large, frequent issuers and smaller, more episodic issuers.

In light of the issues outlined above, we urge that careful consideration be given as to the breadth of the proprietary trading ban contained in the Proposed Rule and provide greater certainty around what constitutes permissible activity. The rule proposal considers several factors in delineating proprietary activities from acceptable market making and customer facilitation. We suggest that dealer "market facilitation" books can be monitored most effectively by focusing first and foremost on aging, followed by value at risk (VAR), correlation, concentration, average tenor, average credit rating, positions in issues where the dealer participated in the syndicate, as well as positions in issues where the dealer did not participate in the syndicate.

As we have seen in the equity markets, evolution does occur and we fully expect over time that fixed income markets will evolve into an "all to all" marketplace with a mix of agency, principal and end-user participants. We welcome a fully integrated market, with an open order book and streaming prices by a myriad of participants providing liquidity. However, until the fixed income markets reach this stage, creating regulatory uncertainty for market makers will likely have a material negative impact on liquidity, resulting in higher borrowing costs for issuers as well as lower returns for investors.

We have additional, specific concerns with respect to the impact of the Proposed Rule on the market for U.S. municipal securities. The municipal market is highly fragmented, made up of millions of individual securities issued by tens of thousands of issuers. A decrease in liquidity in this market could have particularly dramatic impacts for both municipal issuers and market participants. Fortunately, as drafted, the Proposed Rule exempts obligations of any State or of any political subdivision thereof. However, the Proposed Rule fails to extend this exemption to debt issued by an agency of any State or political subdivision thereof, leaving out a significant

portion of the current municipal market for no apparent policy reason. This includes the revenue bond market, creating a negative impact on the ability of municipal issuers to borrow for important projects such as roads, airports, and hospitals. We urge that action be taken to address this inconsistency and adopt a broad exclusion for municipal debt.

Impact on Global Competitiveness of Asset Management

Similar to our concerns with respect to proprietary trading, we believe that the implementation of the prohibition on sponsoring and investing in hedge funds and private equity funds has been drawn too broadly in the Proposed Rule, and impacts activity that Congress did not intend to restrict through the Volcker Rule. Specifically, the proposed definition of "similar funds" is overly expansive and would capture, we believe unintentionally, a wide variety of funds that a diversified asset management firm offers to its clients globally[2]. While a firm that engages solely in the U.S. hedge fund or private equity fund businesses would feel little impact from such an expansive definition, it creates adverse consequences for any firm that offers other types of funds to clients within and outside the United States.

This provision, with its reference to the Investment Company Act of 1940 (the "Investment Company Act"), lacks enough clarity to permit a clear interpretation and as a result could have a significant impact on global-scale asset managers. It effectively represents an extra-territorial expansion of U.S. law, as it requires asset managers to consider each fund that they offer outside the United States and assume that such fund is being offered in the United States. Asset managers then have to determine whether a fund would fit within the broad definition of "investment company" under the Investment Company Act, and if so analyze on what basis the fund could be offered to U.S. persons. Unless the fund

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[2] The Proposed Rule defines similar funds to include: any issuer, as defined in section 2(a)(22) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(22)), that is organized or offered outside of the United States that would be a covered fund as defined in paragraphs (b)(1)(i), (ii), or (iv) of this section, were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States. Proposed Rule § __.10(b)(1)(iii).

could theoretically register as an investment company under the Investment Company Act or satisfy the specific conditions of another exemption or exclusion under the Investment Company Act, the only available means of offering in the United States would be under either Sections 3(c)(1) or 3(c)(7). Therefore, this proposal would appear to turn nearly any non-U.S. fund (including traditional long-only fixed income and equity funds) into a covered fund simply because they could be offered privately in the U.S.

The proposed rule appears to capture most funds sponsored around the world by asset management businesses subject to the Volcker Rule, including the equivalent product to a U.S. registered fund but offered outside the U.S. under another country's regulatory framework (i.e., UCITS funds). Aside from the impact on U.S. based asset management firms that offer funds outside the United States, it seems overreaching and inappropriate to export the requirements of the Investment Company Act to other regulatory jurisdictions.

The result of this expansion is to create dramatic impacts on the activities of asset managers subject to the Volcker Rule that offer funds outside the United States. The repercussions are that numerous funds that were never intended to be captured by the Volcker Rule become subject to its requirements, without any commensurate protection to taxpayers. We recognize the regulators' desire to capture certain funds operating outside the United States that have characteristics similar to those of hedge funds and private equity funds. Unfortunately, the mechanism in the Proposed Rule does not appropriately accomplish that goal, but is instead overbroad and captures almost every fund offered outside the U.S. We believe the right way to capture funds that are "similar" to hedge fund and private equity funds is to create a definition that is based on the characteristics of those funds. This was the

approach proposed in the Volcker Rule study issued last year by the Financial Stability Oversight Council.[3]

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We thank the Subcommittees for providing BlackRock the opportunity to express its views on these important aspects of the Volcker Rule and its proposed implementation. We welcome a continued dialogue on these significant issues.

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[3] Financial Stability Oversight Council, Study and Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds and Private Equity Funds (January 18, 2011).