**Testimony of**

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

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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.

United States House of Representatives
Committee on Financial Services

# "TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

**1. Name:**

Alexander Marx

**2. Organization or organizations you are representing:**

Fidelity Management & Research Company

**3. Business Address and telephone number:**

[redacted]

**4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**

☐ Yes ☑ No

**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**

☐ Yes ☑ No

**6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.**

I am not aware that Fidelity Management & Research Company or any other Fidelity Investments company has received a Federal grant or contract since October 1, 2008 related to our mutual fund business. However, for purposes of completeness, I wish to disclose that the Fidelity funds regularly purchase securities from the U.S. Treasury and various Federal agencies, and have from time to time served as investment vehicles for various Federal entities, including the FDIC, Fannie Mae, Freddie Mac and Federal Home Loan Banks. Additionally, Fidelity money market funds participated in the U.S. Treasury's Temporary Guarantee Program for Money Market Funds during the relevant period.

**7. Signature:**

*Please attach a copy of this form to your written testimony.*