Testimony of James Roselle, Northern Trust Corporation

Before a hearing of the Subcommittee on Financial Institutions and Consumer Protection

May 9, 2012

Good afternoon Chairman Brown, Ranking Member Corker, and members of the Committee:

My name is James Roselle; I am the Associate General Counsel for Northern Trust Corporation, a global financial services firm that provides investment management services, asset and fund administration, and fiduciary and banking solutions to corporations, institutions, and individuals worldwide. As of March 31, 2012, Northern Trust has over $4.6 trillion in assets under custody and $700 billion in assets under management. I appreciate the opportunity to testify before you today on behalf of Northern Trust.

Northern Trust supports the very positive efforts of Congress and this Committee to put in place reforms that reduce systemic risk to the financial system and prohibit high-risk activities that contributed to the financial crisis. As regulators and market participants continue work on implementing and complying with the new financial reform law ("Dodd-Frank Act"), I would like to focus my testimony on specific provisions contained in the Proposed Rule[1] issued pursuant to the so-called "Volcker Rule."[2]

The restrictions and prohibitions set forth in the Volcker Rule were intended to limit banking organization exposure to high risk proprietary trading and investment activities. As a global custody bank and asset manager, Northern Trust does not engage in the types of activities

[1] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011)

[2] Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Section 13 of the Bank Holding Company Act of 1956, as amended)

that the Volcker Rule intended to prohibit. Specifically, Northern Trust does not engage in high-risk proprietary trading and investment activities. Because of the traditional nature of our core banking business, we anticipated that the Volcker Rule would have little or no impact on our business. Before the Dodd-Frank Act was passed, former Federal Reserve Board Chairman Volcker stated that "[c]ustody and safekeeping arrangements for securities and valuables" are among the core banking functions that must remain permissible under the Volcker Rule.[3]

The rules as currently proposed, however, will adversely impact traditionally low-risk business activity that investors rely upon for investment management purposes. This impact is contrary to the stated intention of Congress; it will not promote the safety and soundness of the U.S. financial system and may in fact increase systemic risk. If not corrected in the rule-making process, a core banking business of Northern Trust and other U.S. banking companies will be adversely impacted, which may ultimately impair the competitiveness of U.S. banks in a business where we are the acknowledged global leaders.

Today I will discuss three parts of the Proposed Rule to implement the Volcker Rule that may significantly affect Northern Trust and our clients. Our key concerns are: (1) the overly broad definition of "covered fund" and the impact that so-called "Super 23A"[4] prohibitions will have on custody-related transactions with many clients; (2) the proposed inclusion of foreign exchange swaps and forwards in the proprietary trading restrictions; and (3) the unnecessary and onerous proposed compliance requirements.

First, the Proposed Rule unnecessarily includes a broad range of funds that banking entities will be restricted from sponsoring or investing in. The definition of "covered fund"

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[3] *See Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies* before the S. Comm. On Banking, Housing & Urban Affairs, 111th Cong. 2(February 2, 2010)(testimony of the Honorable Paul Volcker, Chairman, President's Economic Recovery Advisory Board).

[4] Section 13(f) of the Bank Holding Company Act, as amended

would capture nearly all foreign funds (including those that are similar to U.S. regulated mutual funds that are exempt from the Volcker Rule), all funds that trade futures, swaps or other commodity interests to any extent (including U.S. mutual funds)[5], as well as many other entities that do not have traditional hedge fund or private equity fund characteristics. This definition is important because, if a bank is deemed to be a "sponsor" or "adviser" to a "covered fund," then under the Proposed Rule the bank is prohibited under the Super 23A requirements from providing any credit whatsoever to the fund.

Custody banks such as Northern Trust are among the leading global providers of asset management and custody services to the many foreign funds that do not share the characteristics of hedge funds or private equity funds but nevertheless fall within the proposed definition of "covered fund." Moreover, our custody services often include ancillary services that may cause us to be deemed a "sponsor" for a client's fund under the Proposed Rule. If large numbers of sponsored or advised foreign funds become subject to the Volcker Rule, the custody banks will be prohibited from providing traditional operational extensions of credit and will need to satisfy onerous compliance requirements that in some cases may conflict with laws in certain non-U.S. jurisdictions.

Such a sweeping approach is inconsistent with Congressional intent as well as the findings and recommendations of the Financial Stability Oversight Committee ("FSOC") in its study on the Volcker Rule. The legislative history of the Volcker Rule indicates that Congress intended and expected the Agencies to use their rulemaking authority to implement the Volcker Rule in a way that focuses its prohibitions and restrictions on traditional hedge funds and private equity funds. The Proposed Rule expands the universe far beyond the intended scope of the law.

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[5] See attached comment letter from Vanguard dated February 13, 2012, on prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds. http://1.usa.gov/IrG535

To compound the problem, the Proposed Rule adopts an extremely rigid interpretation of the Super 23A restriction that will put at risk traditional payment and settlement services that custody banks provide for their clients. Ordinary custodial and administrative services provided to our clients of necessity must include the provision of intraday or short-term extensions of credit to facilitate securities settlement, dividend payments and similar custody-related transactions. These payment flows are expected in order for transaction settlements to operate smoothly and they have been encouraged by global financial supervisors. Northern Trust and other banks have a robust risk framework to deal with these types of payments, and our risk framework and exposure limits are regularly examined by bank supervisors. Nevertheless, even these low-risk extensions of credit appear to be considered as prohibited "covered transactions" under the Proposed Rule. It is unfortunate that the Proposed Rule has not followed the framework of Section 23A of the Federal Reserve Act[6] and Regulation W, which contain provisions that permit these low-risk operational exposures subject to well-established risk management standards.

These custody-related transactions simply do not give rise to the type of risk that the Volcker Rule was intended to address. Prohibiting them will encourage covered fund clients to make alternative arrangements for custodial and administrative services with non-U.S. banks, which will damage the competitive position of Northern Trust and other U.S. banks. Moreover, prohibiting these transactions could result in market disruption and elevated levels of risk in global payment and settlement systems, with no corresponding systemic or firm-specific risk reduction.[7] Northern Trust believes the agencies have ample authority to craft a rule that does not have these unintended and adverse consequences for a traditional core banking activity.

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[6] 12 U.S.C. Section 371c

[7] *See* comment letter from BNY Mellon, Northern Trust, and State Street dated February 13, 2012, on proposed rulemaking implementing the Volcker Rule-Hedge Funds and Private Equity Funds. http://1.usa.gov/Jjgh9b

Second, the proposed inclusion of foreign exchange swap and forward transactions within the proprietary trading prohibitions will result in damage to a traditional and low-risk activity, with no offsetting benefit to the U.S. financial system.[8] As a significant global custodian and asset manager, Northern Trust carries on an active foreign exchange trading operation that is directly related to our core client services. Foreign exchange transactions typically are generated as a result of the routine purchase or sale of securities, or the receipt or payment of income, dividends or redemptions, by or for our clients. In essence, these currency transactions are simple cash management transactions used by our clients to efficiently manage cross currency needs.

Secretary Geithner cited the key differences between foreign exchange transactions and other types of derivatives in his proposed determination to exclude foreign exchange swaps and forwards from the clearing and settlement requirements of Title VII of the Dodd-Frank Act.[9] The proposed determination correctly concluded that foreign exchange swaps and forwards "already reflect many of Dodd-Frank's objectives for reform including high levels of transparency, effective risk management, and financial stability." Foreign exchange swaps and forwards have fixed payment obligations, are physically settled, and are predominately short-term instruments; therefore the risk profile is different from other derivatives. This is a traditional banking activity that is clearly not required by statute to be included in the Volcker Rule's proprietary trading ban and, for the reasons stated above, should be excluded from the Rule's trading restrictions.[10]

Third, the compliance requirements of the Proposed Rule are unduly burdensome and will unnecessarily increase compliance costs for banks with little or no offsetting benefit. The

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[8] *See* attached comment letter from Northern Trust dated February 13, 2012, on proposed rulemaking implementing the Volcker Rule – Proprietary Trading. http://1.usa.gov/IJVcsd

[9] "Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act" issued by the Department of the Treasury on April 29, 2011.

[10] With respect to the proprietary trading portions of the Volcker Rule, Northern Trust concurs with the attached comment letter submitted by SIFMA's Asset Management Group dated February 13, 2012, on restrictions on proprietary trading and certain interests in and relationship with hedge funds and private equity funds. http://1.usa.gov/IB2ldf

Proposed Rule essentially requires the bank to prove that each transaction does not fall within the prohibited category. At Northern Trust, a very high percentage of trading assets reported on our Call Report are foreign exchange transactions that, for the reasons given above, should be excluded from the trading restrictions. We have very small mark-to-market exposures in "plain vanilla" derivatives and securities. Yet, under the Proposed Rule, we would be required to produce a large number of compliance metrics, many of which are poorly designed to reveal evidence of prohibited proprietary trading, resulting in considerable systems expenditures and ongoing costs of compliance. We believe these costs have not adequately been considered by the Agencies in issuing the Proposed Rule. We believe the Agencies could carry out the intent of Congress more effectively and with less cost to the banking system with a simpler rule that is supplemented by active supervision of bank trading risks and practices.

Northern Trust has submitted comments on the Proposed Rule to implement the Volcker Rule restrictions, and we have had meetings with the Agencies to discuss our concerns. I am confident that the Agencies will seriously consider the comments received, and that the final rule, or a re-proposal of the Proposed Rule, will deal more effectively with the intended purpose of the Volcker Rule and avoid adverse unintended consequences.

We believe that our conservative and highly focused business model is one that contributes to financial stability and long-term benefits for our clients, shareholders and employees. As the rule-making phase continues, we urge this Committee to encourage the Agencies to adopt final regulations that do not adversely impact those traditional business activities that played no role in causing the financial crisis. These activities provide market participants with efficient and safe investment management services. Preserving such business models will ensure that U.S. banks can operate competitively while protecting against negative impacts on the broader economy and U.S. employment.

Thank you Chairman Brown, Ranking Member Corker, and members of the Committee, for allowing me to present Northern Trust's views on this critically important topic.