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February 13, 2012

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th St. and Constitution Avenue N.W.
Washington, D.C. 20551

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Mr. John G. Walsh
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Re: Prohibitions and Restrictions on Proprietary Trading, etc. (OCC: OCC-2011-14, FRS: Docket No. R-1432 and RIN 7100 AD82, FDIC: RIN 3064-AD85, SEC: S7-41-11)

Dear Chairman Bernanke, Acting Chairman Gruenberg, Secretary Murphy, and Acting Comptroller Walsh:

Americans for Financial Reform ("AFR"), the American Federation of Labor – Congress of Industrial Organizations ("AFL-CIO"), and the Federation of State Public Interest Research Groups (U.S. PIRG) appreciate this opportunity to comment on "Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds".

AFR is a coalition of over 250 national, state, local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups along with prominent independent experts.

The AFL-CIO is the country's largest labor federation and represents 12.2 million union members. Union-sponsored pension and employee benefit places hold more than $480 billion in assets. Union members also participate directly in the capital markets as individual investors and as participants in pension plans sponsored by corporate or public-sector employers.

U.S. PIRG serves as the Federation of State Public Interest Research Groups, with members around the country. State PIRGs are non-profit, non-partisan public interest advocacy organizations that take on powerful interests on behalf of their members in areas including consumer protection, good government and public health.

This letter is in response to the joint request for comment by the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Department of the Treasury, and the Securities and Exchange Commission ("the Agencies") on the proposed rule to implement Section 619 of the Dodd-Frank Act, also known as the 'Volcker Rule'.

Summary

There are significant positive elements in this proposed rule. But it still falls well short of fully implementing the statute. It is clear from both the legislative history and the text of the statute that in passing the Volcker Rule Congress sought fundamental change in the American financial system by restoring basic firewalls between the banking system and the capital markets. In the proposed rule, the regulators have not placed the statutorily required limitations on permitted capital market activities. Instead, they have gone to some effort to preserve business as usual in important areas. This includes practices at the center of the financial crisis, such as dealing in illiquid and customized products for which no market exists and bank participation in securitizations. The metrics-based oversight regime favored by the regulators here, while positive in many respects, simply will not work unless it is accompanied by clear restrictions on the scope of permitted activities.

Fortunately, a number of specific changes in the proposed rule could satisfy statutory intent and bring the benefits envisioned by the framers of this law. These include:

- Restricting permitted activities such as market making and underwriting to market-traded instruments for which an external price exists.

- Ensuring tough and workable limitations on overall capital market inventories.

- Reforming trading account oversight to ensure coverage of arbitrage trades and prevent proprietary trading in securities held for periods longer than two months.

- Replacing the current securitization exemption with a specific safe harbor based around carefully pre-specified securitization structures. The current exemption in the rule has promising elements conceptually, but it is simply too broad.

- Reforming the overly broad exemption for repo and securities lending transactions by creating a safe harbor based on prudent practices.

This comment contains a number of other specific recommendations, including suggestions for reforming the customer definition. We also highlight positive areas of the rule, such as the scope of the oversight regime, which is clearly mandated in the statute.

INTRODUCTION

Overview – The Scope of the Rule

Section 619 is correctly considered to be one of the centerpieces of the Dodd-Frank financial reforms. It is helpful to briefly review the history, intent and structure of the statute. The idea of a ban on proprietary trading was first publicly advanced as a concept in the January, 2009 Group of 30 report undertaken in response to the global financial crisis of 2008.[1] The intent of the ban was sweeping:

> "Recent experience in the United States and elsewhere has demonstrated instances in which unanticipated and unsustainably large losses in proprietary trading, heavy exposure to structured credit products and credit default swaps, and sponsorship of hedge funds have placed at risk the viability of the entire enterprise….These activities, and the "originate-to-distribute" model, which facilitated selling and reselling highly engineered packages of consolidated loans, are for the most part of relatively recent origin. In essence, these activities all step away from the general concept of relationship banking, resting on individual customer service, toward a more impersonal capital markets transaction-oriented financial system. What is at issue is the extent to which these approaches can sensibly be combined in a single institution, and particularly in those highly protected banking institutions at the core of the financial system."

In other words, the proprietary trading ban was advanced as a way of shielding the core institutions of the financial sector from the capital market exposure that had led to the 2008 crisis. The report correctly recognized, as many other observers have, that the shift of vital credit intermediation to dealers motivated by the prospect of immediate proprietary profits in the capital markets had created profound instability in the system.

The July 15, 2010 colloquy between Senators Merkley and Levin, the drafters of Section 619, lays out in detail the origins and intention of the statute itself.[2] Senator Merkley describes the 2008 financial crisis, as well as the increasing financial instability that preceded it as finance was deregulated, as the motivation for the statue and the Group of 30 report as the specific inspiration. He echoes the theme that this legislation has broad systemic intent:

> "The 'Volcker Rule'…embraces the spirit of the Glass-Steagall Act's separation of 'commercial' from 'investment' banking by restoring a protective infrastructure around our critical financial infrastructure….While the intent of Section 619 is to restore the purpose of the Glass-Steagall barrier between commercial and investment banks, we also update that barrier to reflect the modern financial world…"

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[1] Group of 30, "Financial Reform, a Framework for Financial Stability", January 15, 2009, Group of Thirty. Available at: www.group30.org/images/PDF/Financial_Reform-A_Framework_for_Financial_Stability.pdf

[2] Colloquy of Senators Levin and Merkley, Congressional Record, July 15, 2010, p. S5894-S5899, available at http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

Continuing in the colloquy, both Senators emphasize the broad sweep of the specific statutory provisions, as is necessary to fulfill the statutory goals.

Of course, the central issue is the language of the statute itself. Here, the broad scope and systemic intent of the Volcker Rule are unmistakable. Section 619 adds a new Section 13 to the Bank Holding Company Act. This new section is structured as follows:

1) Section 13(a)(1) bans all proprietary trading and ownership interests in hedge or private equity funds.

2) Section 13(h)(4) defines "proprietary trading" broadly as any principal trading from a bank trading account (defined in terms similar to those used by regulators to designate the bank's trading book). Section 13(a)(1) therefore bans any securities activity in the bank trading book where profits or losses are sustained by the bank itself.

3) Section 13(h)(2) defines 'hedge and private equity funds' broadly as any fund covered by the c(1) and c(7) exemptions of the Investment Company Act.[3]

4) Section 13(d)(1) then instructs regulators to allow a number of permitted activities within the two broad bans set out in 13(a)(1). These include market making, underwriting, risk-reducing hedging, and offering and making limited investments in covered funds.

5) However, Section 13(d)(2) then immediately qualifies the scope of these permitted activities. It states categorically that no transaction or activity may be permitted under the 13(d)(1) activities in cases where such an activity:
    a. poses a threat to the safety or soundness of the bank
    b. poses a threat the financial stability of the United States
    c. creates conflicts of interest with customers
    d. exposes the bank to high-risk assets or trading strategies.

6) Section 13(d)(3) then also states that the regulators shall impose additional capital and quantitative limitations on the 13(d)(1) permitted activities if such limitations are necessary to ensure the safety and soundness of the bank.

This structure aligns with the legislative history of the statute. The broad ban on both proprietary trading and fund investments recreates in updated terms the firewall between bank activities and

[3] In addition, most funds or issuers covered by other Investment Company Act exemptions would be swept into Volcker Rule coverage by the Section 13(h)(1) definition of 'banking entity' to include all affiliates or subsidiaries of a bank holding company. See the discussion at CFR 68854 of the Proposed Rule.

capital markets that characterized the Glass-Steagall age of relationship banking. In recognition of a range of customer-oriented activities offered in modern financial markets, certain permitted activities are allowed within this ban, but subject to important qualifications. Thus, market making and hedging are forms of banned principal trading, but they are permitted under the Section 13(d)(2) conditions. These conditions ensure that permitted activities may not be used to shelter activities or transactions that threaten the soundness of the bank or the stability of the financial system as a whole (i.e. create systemic risk). Should regulators need additional tools to ensure that the 13(d)(2) conditions are met, they are enjoined to impose capital and liquidity limitations on permitted activities to ensure undue risk is not created.

This statutory framework thus mandates a broad reading of the proprietary trading ban. This has apparently not been understood by some commenters on the rule. For example, Peter Kraus of Alliance Bernstein has stated that[4]:

> "The proposed regulations also start from the principle that almost everything that market makers do is prohibited and that the government should allow only a few specific exceptions to continue….I'd like the regulators who wrote the implementing regulations to....treat what market makers do as mostly right (with exceptions), rather than as mostly wrong."

This attitude reflects that of a number of industry critics of the Proposed Rule. However, it is at odds with the statute itself. As outlined above, the law mandates that regulators start with a broad prohibition on capital market activities by regulated banks, and then carve out limited exemptions within that framework, subject to risk oversight. This does not mean that regulators are unable to offer scope for activities that are legitimately classified permitted activities such as market-making or hedging. The statute grants regulators significant discretion to define the scope of permitted activities, so long as this does not lead to a violation of the 13(d)(2) restrictions (e.g. by creating systemic risk). But regulators are statutorily required to start with a sweeping prohibition on capital market activities and then carefully examine activities permitted within that prohibition.

The Volcker Rule And Systemic Risk

Some critics of the Volcker Rule have expressed the view that the Volcker Rule is misguided, as proprietary capital market activities by major banks were not related to the financial crisis of 2008 and did not create systemic risk.[5] This view ignores the actual scope of the pre-crisis trading operations at systemically significant banks, which were extensive.[6] It rests on a very

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[4] Kraus, Peter, "For Volcker Rule, The Devil Is In the Details", Context, The Alliance Bernstein Blog On Investing, January 12, 2012. Available at http://blog.alliancebernstein.com/index.php/2012/01/06/for-volcker-rule-the-devil-is-in-the-details/

[5] See e.g. Hal Scott, Testimony Before U.S. Senate Banking Committee, Feb. 4, 2010.

[6] Crotty, James, Gerald Epstein, and Irena Levin, "Proprietary Trading Is A Bigger Deal Than Many Bankers and Pundits Claim", Political Economy Research Institute, Policy Notes Number 15, February 18, 2010.

narrow definition of "proprietary trading" that does not reflect the actual sweep of the statutory ban. As discussed above, the statute clearly does contain a systemic risk mandate (in Section 13(d)(2)), and its legislative drafters clearly understood themselves to be addressing systemic risk.

The relationship between the Volcker Rule and systemic risk is easier to see once the statutory scope of the proprietary trading and fund investment ban is understood. Section 619 bans all principal trading from trading accounts, and then permits particular activities only on the condition that they do not create systemic risk. Furthermore, it strongly limits bank relationships with off-balance sheet entities that include both hedge and private equity funds and the various intermediaries and conduits used in securitization.

This is effectively a mandate to address problems in the bank trading book and in securitization. It is very clear that these were at the center of the 2008 crisis. Trading book capital treatment permitted banks to use short-term risk metrics based on market prices to conceal tail risk on the trading book. This was crucial to arbitraging capital standards. By the time of the crisis capital standards for trading book activities had been so thoroughly undermined that trading book activities were massively undercapitalized compared to conventional banking book activities.[7] The securitization pipeline created massive amounts of 'toxic assets', many of which were stockpiled on bank trading books where they supported excessive leverage through repo.[8] The spread of securitization

The almost total failure in oversight of trading book activities and the relationship of this failure to the crisis is widely acknowledged by regulators worldwide.[9] Most of the changes in Basel III capital rules were devoted to increasing trading book capital. However, the Basel III framework still relies on accurately measuring trading book risks and tailoring capital standards precisely to these risks. This is an enormous challenge and the history of arbitrage of these capital rules over the past two decades is well known.[10] Since regulators are apprehensive that the new capital standards may not fully address the problem, a comprehensive review of trading book oversight and activities is high on the future agenda of the Basel committee.[11]

Implemented properly, the Volcker Rule should act as a powerful complement to improved capital rules, not a substitute or distraction from them. Given unlimited freedom to expand the scale and complexity of their trading book activities, banks have historically been able to

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[7] U.K. Financial Services Authority, "The Turner Review: A Regulatory Response to the Global Banking Crisis", March, 2009.
[8] Gorton, Gary B. and Metrick, Andrew, "Securitized Banking and the Run on Repo", November 9, 2010. Yale ICF Working Paper No. 09-14.
[9] Financial Services Authority, "The Prudential Regime For Trading Activities", Discussion Paper 10-4, August 2010.
[10] A. Blundell-Wignall, P. Atkinson, "Origins of the Financial Crisis and Requirements for Reform", Journal of Asian Economics (2009), doi:10.1016/j.asieco.2009.07.009.
[11] Pengelly, Mark, "Delayed Basel Trading Book Review Will be Broad", Risk Magazine, October 5, 2011

arbitrage trading book capital rules by creating instruments that showed little variance in value during 'normal' market conditions but had enormous concealed tail risks in stressed market conditions. By instituting restrictions on the scale, scope, and complexity of trading book activities at key banks which are at the center of the financial system, an effective Volcker Rule will greatly simplify the task of understanding trading book risks and assigning proper capitalization to such risks.

To take another perspective on the same set of problems, the production and stockpiling of "toxic" securities prior to the crisis was motivated by the enormous proprietary gains to be had through conversion of conventional mortgage lending into complex, opaque securities. These securities were novel structures that did not have deep, liquid markets with transparent or reliable prices. Their values were often 'marked to model' by banks and rating agencies in ways that concealed extensive tail risks. When these risks materialized under stressed market conditions the previous lack of true risk transparency led markets to freeze. Indeed, research on the causes of the 2008 crisis has shown that subprime securitization markets were so opaque that they began to collapse as soon as even approximate price and risk data became publicly available through the ABX index.[12] The collapse of the subprime market then spread to other markets due to the connections created through repo lending, derivatives, and parallel trading positions in crowded trades, quickly eviscerating what little capital these firms had built up.

The utility of the Volcker Rule's systemic firewall between high-risk trading and depository banks depends upon dramatic strengthening of the bulkheads between these parts of the financial system. By limiting trading book activity to *bona fide*, traditional market making and hedging, the Volcker Rule can ensure that bank exposure is limited to deep, well understood markets with more reliable liquidity. The restriction of trading book activities to bona fide market making, underwriting, and hedging should result in restricting the total securities inventory at systemically critical banks, since the traditional forms of these activities do not require extensive inventories. This will in turn limit the ultimate potential loss in a stressed market, and therefore reduce propagation of risk across markets with crowded trades and add to the resiliency of the financial system.

A vital consideration in designing the Proposed Rule is that many of the most systemically risky forms of proprietary trading engaged in by banks were labeled as activities that are, at least nominally, permitted under the Volcker Rule. For example, dealer banks structured, sold, and built inventories of complex, illiquid mortgage backed securities under the rubric of 'market making' and 'underwriting'.[13] They engaged in so-called 'hedging' that involved large short bets on the housing market, using these hedges to create huge volumes of synthetic CDOs that broke the link between real economy activity and securities issuance while involving severe conflicts

[12] Gorton, Gary B., "Information, Liquidity, and the (Ongoing) Panic of 2007" (January 7, 2009).
[13] Dunbar, Nicholas. *The Devil's Derivatives*. Boston, Massachusetts: Harvard Business Review Press, 2011.

of interest with clients.[14] The Volcker Rule statute was designed to address these problems directly, and the fact that firms previously engaged in practices under the same *rubrics* does not mean that the same *activities* can continue as before. These activities would not in fact satisfy the requirements of the statute, be it on the grounds of permitted activities or by way of the limitations of 13(d)(2) with respect to systemic and prudential risk. A major theme of this comment will be the ways in which the Final Rule should be structured to ensure that bank capital market activities are genuinely limited to the activities described in the statute as permissible.

The Volcker Rule and Market Liquidity

Many critics have expressed the concern that the implementation of Section 619 will create adverse effects on market liquidity because trading affiliates of large banks will be limited by market making restrictions and higher capital costs. This will lead to costs for market participants.

This criticism is deeply misguided. First, it ignores the fragility of market liquidity over time and its connection to systemic risk. This connection is at the heart of the global financial crisis that motivated the Volcker Rule. Second, it ignores the benefits of moving liquidity provision related to proprietary trading away from large systemically critical banks, which benefit from an implicit public subsidy, to smaller traders who are not systemically significant.

In recent years economists have made important advances in understanding the dynamic nature of market liquidity, its relationship to funding liquidity, and its connection to systemic risk. The key finding of this literature is that liquidity is fragile and vulnerable to "liquidity spirals" fed by the interaction of market and funding liquidity. In these spirals, a high level of market liquidity during one period feeds a sharp decline in liquidity during the next period – essentially a bubble and then a crash. Periods of high market liquidity drive asset prices upward, which supports increased leverage by market speculators, which in turn drives asset prices still higher. This creates dangerous financial instability. When events reveal that assets are overpriced, market speculators must sell assets in order to reduce their leverage. These "fire sales" can cause a self-reinforcing collapse of the financial system as speculators flee declining markets.

Such liquidity spirals are well supported theoretically and empirically in the leadup to the 2008 crisis.[15] NYU economist Lasse Pederson summarizes the situation:[16]

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[14] Smith, Yves. *Econned,* New York, NY: Palgrave McMillan, 2010.
[15] Brunnermeier, Markus K. and Pedersen, Lasse Heje, "Market Liquidity and Funding Liquidity" (June 2009). *The Review of Financial Studies*, Vol. 22, Issue 6, pp. 2201-2238, 2009. Brunnermeir, Markus, K. "Deciphering The Liquidity and Credit Crunch of 2008", *Journal of Economic Perspectives*—Volume 23, Number 1—Winter 2009.
[16] Pedersen, Lasse Heje, "When Everyone Runs for the Exit", November 2009. NYU Working Paper No. FIN-09-025.

> "In the years preceding the crisis, the global financial markets were flush with liquidity due to low interest rates, high savings rates in Asia, economic growth, and low volatility. As a response to low borrowing costs and low apparent risk, financial institutions became highly levered (a positive liquidity spiral). This made them vulnerable. When house prices started to decline and it started to become clear in 2007 that subprime borrowers would default in large numbers, an adverse liquidity spiral was kicked off. Many banks experienced significant mark-to-market losses, and two hedge funds at Bear Stearns blew up due to subprime-related collateralized debt obligations (CDOs) in June 2007. Market liquidity dried up in one market after another as volatility picked up, funding became tight, and risk premia rose…"

The existence of excessive market liquidity (a credit bubble) prior to the 2008 crisis was readily apparent to market participants at the time.[17] But the intensity of proprietary profit incentives – the drive to squeeze all the short-term revenues possible out of the bubble – made it difficult to disengage from the process. The dynamic was well described by Chuck Prince of Citigroup[18]:

> "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

Indeed, prior to the crisis it was commonplace to see discussions of a "liquidity glut" or "wall of liquidity" that worked to compress spreads to an unhealthy degree.[19] This led to a search for yield that weakened underwriting standards enormously. There is little evidence that the flood of liquidity increased economic efficiency or productivity. Indeed, the decade of the liquidity bubble saw the lowest GDP growth of any decade since WWII. It was marked by low levels of business investment and what in retrospect was a massive capital misallocation into residential investment.[20] Notably, this period was also marked by a massive increase in capital market trading volumes, but no corresponding growth in real economy investment. This contrast has led economists to find that the U.S. financial system actually became less efficient in generating economic growth over recent years, despite high market trading volumes and apparent liquidity.[21]

A goal of the Volcker Rule is clearly to protect the financial system by preventing destabilizing liquidity bubbles and the liquidity crashes that eventually result. It does this by tightly restricting the exposure of banking institutions – those most likely to benefit from an implicit or explicit public guarantee – to the high-powered incentives created by proprietary trading on the capital

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[17] Berman, Dennis K. 2007. "Sketchy Loans Abound: With Capital Plentiful, Debt Buyers Take Subprime-Type Risk." *Wall Street Journal*, March 27, page C1.
[18] Nakamoto, Michiyo, and David Wighton, 2007. "Citigroup Chief Stays Bullish on Buyouts." *Financial Times*, July 9, 2007.
[19] Rajan, Raghuram, "Investment Restraint, the Liquidity Glut, and Global Imbalances", Remarks by Raghuram G. Rajan, Economic Counselor and Director of Research, IMF At the Conference on Global Imbalances organized by the Bank of Indonesia in Bali November 16th 2006
[20] Chinn, Menzie and Jeffry Frieden, Lost Decades: The Making of America's Debt Crisis and The Long Recovery, W.W. Norton, 2011.
[21] Philippon, Thomas, Has the U.S. Finance Industry Become Less Efficient? (December 2011). NYU Working Paper No. FIN-11-037.

markets. It is these incentives that drive the liquidity spiral, as speculators rush to profit during an asset bubble and then rush to the exits when markets turn against their proprietary positions. Furthermore, it is the subsidy to leverage created by the implicit public guarantee that helps fuel excessive leverage during the 'bubble' phase of a liquidity spiral.

The latter point is important. The chances of destabilizing systemic risk due to liquidity spirals are heightened when speculators benefit from an implicit public backstop. The most dangerous liquidity spirals are fed by excessive leverage obtained during a bubble, which then forces 'fire sales' in stressed markets. Institutions which are seen as "too big to fail" find it much easier to obtain high leverage, as lenders see some possibility for a government bailout.[22] Smaller traders are much more subject to market discipline.

As banking institutions exit proprietary trading, smaller traders such as non-systemically significant broker-dealers and hedge funds have every reason to take proprietary risks that are economically rational absent the implicit public subsidy backing banks and systemically significant financial institutions. The Volcker Rule does not limit the ability of such non-systemically critical institutions to do proprietary trading at all. To the extent that proprietary trading is profitable, capitalist rational actors, like hedge funds, can therefore be expected to replace a substantial share of reasonable (non-excessive) market liquidity. For example, in the corporate bond market, one key market that critics have claimed could be threatened by the strong Volcker Rule implementation, it is clear that hedge funds would have the financial capacity to step in to provide significant liquidity relative to what large dealer banks provided. Current hedge fund assets are over $2 trillion, which is several times the peak inventory level of roughly $200 billion in corporate bond inventory held by primary dealers before the crisis, and many times the current level of $43 billion.[23] And, to the extent that this market liquidity is only a function of the implicit subsidy provided by the "too big to fail" backstop, then any reduction in liquidity is appropriate and healthy for a genuinely capitalist system.

Section 619 thus takes a reasoned and well-supported approach to the issue of market liquidity. By restricting the ability of systemically significant institutions to engage in proprietary trading, the Volcker Rule may temporarily reduce trading volume and excessive liquidity at the peak of market bubbles. But it should increase the long-run stability of the financial system and render genuine liquidity and credit availability more reliable over the long term. It will also make it more likely that the proprietary speculation that does occur is engaged in by smaller institutions that are genuinely risking their own capital. In cases where it is profitable to provide liquidity through speculative trading, it will continue to be provided by such institutions.

For regulators to be justified in weakening Section 619 restrictions in order to enhance liquidity, it must be demonstrated that this will not undermine the statutory mandate to address the systemic risks potentially created by excessive liquidity. Furthermore, they must show that any liquidity losses will not be replaced by smaller non-bank financial institutions that pose less risk

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[22] Baker, Dean and Travis MacArthur, "The Value of the 'Too Big to Fail' Bank Subsidy", Center for Economic and Policy Research, Issue Brief, September, 2009.

[23] Federal Reserve Bank of New York, Primary Dealer Statistics, Available at http://www.ny.frb.org/markets/gsds/search.cfm . Data is for corporate bonds with maturity of one or more years, for peak period for 2001-2007 and week of February 6th, 2012.

to the system. The reallocation of speculative proprietary trading to such smaller institutions was also part of Congressional intent in the statute.

Criticisms of the Volcker Rule for reducing market liquidity do not grapple with these issues. The liquidity arguments advanced by those opposed to the rule do not address systemic risk or the possibility of future financial crises driven by similar liquidity dynamics to the crisis of 2008. Instead, they simply claim that large banks may at some point be less able to provide liquidity to the market because of proprietary trading restrictions, and that this could potentially affect asset prices at a point in time. Estimates of asset price reduction have no dynamic or over-the-cycle properties, even though recent research and experience demonstrate that liquidity provision has important implications for market stability over time. Ironically, the major industry study that attempted to quantify the asset price impacts of liquidity reductions takes the liquidity price impacts of the 2007-2009 financial crisis – the impact of a severe market collapse caused by excessive liquidity and leverage before the crisis – and applies these costs to the Volcker Rule.[24] This amounts to taking the costs of the financial crisis and ascribing them to a strong implementation of Section 619. A more justified approach would be taking these costs as a *benefit* of Volcker Rule implementation, as if such a rule were in place it could have greatly moderated or perhaps prevented the crisis.

Summary Of Top Priorities In Comment

The detailed discussion below is devoted to giving regulators specific suggestions for ways to improve the proposed rule and ensure that the full potential of the Volcker Rule to safeguard the American financial system is realized. This goal can only be achieved if banks are limited to genuine, bona fide, market making, underwriting, and hedging activities, and if bank relationships with external and off balance sheet funds are properly restricted as intended by the statute. Here are some key priorities.

The scope of the rule and the oversight regime is a positive aspect of the rule and must be maintained: The Agencies have correctly understood that the statute requires broad coverage of trading activities, and also requires permitted activities to be placed under significant oversight. Especially important is the identification of the 'trading account' with all positions governed by the market risk capital rules, which directly aligns coverage of proprietary trading with a key mechanism used by banks to evade capital requirements. The range of covered financial positions defined in the rule is also extensive and appropriate (although there are a few

[24] Oliver Wyman, The Volcker Rule Restrictions on Proprietary Trading: Implications For Market Liquidity, February, 2012. The paper draws on Dick-Nielsen, Jens, Feldhütter, Peter and Lando, David, "Corporate Bond Liquidity Before and After the Onset of the Subprime Crisis (May 31, 2011)". Journal of Financial Economics (JFE), Forthcoming. The academic paper measures declines in securities prices associated with lack of liquidity during the pre-crisis period of Q3 2005-Q2 2007, and compares them to price declines during the financial crisis period of Q3 2007-Q2 2009. For investment-grade bonds, price declines associated with low liquidity were over ten times higher during the financial crisis period (see p. 15 of the paper). The Oliver Wyman paper takes price declines from the 2007-2009 financial crisis period and applies them as a multiplier to determine economic effects of the Volcker Rule.

instruments that are inexplicably exempted), as is the extraterritorial scope of the rule. All of these align with the clear intention and mandate of the statute for broad coverage of trading operations.

Control of permitted activities will not be effective if banks are given unlimited scope for market making and underwriting in illiquid assets without a clear external market. Market making fundamentally requires making a two sided market in instruments for which a clear, external market exists. Underwriting involves assisting clients in selling new issues into an existing external market. Both activities are compensated through either fees or spreads on observable external market prices. At times, the Proposed Rule does use this traditional definition. But at other times the Agencies appear to contemplate an unlimited scope for these activities in illiquid markets and 'markets' for customized products, so long as activities satisfy certain quantitative metrics. This is extremely dangerous to the integrity of the rule. The quantitative metrics advanced by the Agencies can easily be gamed if banks are given unlimited scope to design and sell customized products. In the absence of external prices 'market making' in complex products can certainly produce systemic risk and potentially major conflicts of interest with customers, both driven by uncertain valuations. Specific ways to limit such risks are to ban market making and underwriting for assets classified as Level 3 in the FAS 157 fair value hierarchy, and to restrict market making for the purely bespoke or customized elements of derivatives.

Bank securities inventories should be limited across the board, particularly for underwriting activities . If properly defined, the capital market activities permitted to banks under the Volcker Rule clearly should not require large inventories. Both market makers and underwriters typically try to avoid large inventory positions. While certain inventories of securities may be needed to address liquidity needs, this should be limited to highly liquid instruments such as government bonds. The large securities inventories built up at major dealer banks prior to the crisis to ostensibly serve underwriting and market making needs should be a thing of the past. The rule properly cites inventory metrics for both underwriting and market making activities. However, these are only one among many metrics, and there are a number of ways (discussed below) to manipulate inventory metrics. Inventory metrics should be given an especially high priority among the various types of compliance metrics in this rule, and additional resources must be expended to monitor them properly.

A strong definition of 'customer' should be added to the rule. The distinction between activities performed for a customer or client and activities performed purely to benefit the bank itself is central to all elements of Section 619. However, the Agencies elected not to define formally the terms "customer" or "client" in the Proposed Rules, despite using the terms frequently throughout the NOPR. Care must be taken to avoid any definition of customer which permits the bank itself to effectively become its own customer, directly or indirectly. This would effectively restore proprietary trading. A customer should be defined either an unaffiliated person or institution with a preexisting continuing relationship during which the banking entity has provided one or more financial products (customers) or services (clients) prior to the time of the transaction, or alternatively for a new customer as an unaffiliated person who has initiated a relationship with a view to engaging in transactions.

While there are some conceptually promising securitization restrictions already in the rule, the agencies must go further to ensure that these reforms are not undermined. The unlimited ability to structure, underwrite, hold, and sell complex and opaque asset-backed securities was at the heart of the failure of the banking system during the crisis. Section 619 properly restricts the relationships of banks with a wide range of off-balance sheet entities, including issuers of asset backed securities. The regulators go to some lengths to exempt relationships with issuers of asset backed securities from the full scope of Section 619 restrictions. Understanding that if such relationships were absolutely unlimited there would be enormous scope to evade the law, the Agencies do put some conceptual limitations on these relationships. These limits, while a genuine positive step, remain excessively broad and general and need to be strengthened further to ensure protections against systemic risk. We recommend a securitization safe harbor based on exact, pre-specified securitization structures for each asset class. This would improve both market discipline and transparency for structured securities and regulatory oversight capacity.

Regulators must ensure that the rule fully protects against proprietary arbitrage trades. Arbitrage, spread, or carry trades are a classic type of proprietary trade. These trades involve profiting on credit or market spreads between highly correlated assets. They involve somewhat longer holding periods for the underlying assets than speculative market trades. They have been implicated in many of the most spectacular financial collapses of the last few decades, including Long Term Capital Management and the 2008 financial crisis. The combination of an emphasis on short holding periods for underlying assets in the Proposed Rules and also the hedge exemption which permits correlated assets to be classified as hedges, may create a major loophole for arbitrage trading in this rule. Regulators must act to address arbitrage trading, both directly and by addressing issues related to holding periods and oversight of the hedge exemption.

The complete exemption of repurchase (repo) agreements and securities lending from oversight under this rule is misguided. As discussed in the commentary below, repo and securities lending arrangements can easily be used to put on a proprietary trade. In addition, repo creates a particularly tight and instantaneous link between asset market valuations and bank liquidity. This link was at the heart of the financial crisis. Regulators should eliminate the complete exemption for repo and securities lending arrangements granted in this proposed rule. Instead, they should use their Section 13(d)(1)(J) authority to create a new repo permitted activity. This will not require trade by trade examination of repo transactions. Instead, a broad safe harbor should be created that specifies permissible collateral types, haircuts, and contract terms, and limits the extent of overnight repos as a share of total liquidity.

Other issues: Other issues discussed below include the removal of the compensation hedging exemption for investments in covered funds, improvements in conflict of interest standards, recommendations for improvements in compensation metrics and restrictions, and recommendations for improvements metrics and oversight standards.

SPECIFIC DISCUSSION

Below, we discuss specific sections of the rule. Our discussion is ordered according to the sections of the Proposed Rule, with the Appendices discussed under Section 7 on reporting and recordkeeping requirements. The comment mixes free-form discussion and responses to specific questions.

Subpart A – Part 2: Definitions

_2 (e) Banking Entity

Question 9. Under the proposed rule, would issuers of asset-backed securities be captured by the proposed definition of ''banking entity''? If so, are issuers of asset-backed securities within certain asset classes particularly impacted? Are particular types of securitization vehicles (trusts, LLCs, etc.) more likely than others to be included in the definition of banking entity? Should issuers of asset-backed securities be excluded from the proposed definition of ''banking entity,'' and if so, why? How would such an exclusion be consistent with the language and purpose of the statute?

An exclusion for issuers of asset-backed securities from the definition of "banking entity" would be highly inconsistent with the language and purpose of the statute. The statute specifies in 13(h)(1) that "any affiliate or subsidiary" of a banking entity is covered under the banking entity definition. Of course, the statute also strictly and specifically limits relationships with all funds making use of the 3(c)(1) and 3(c)7 exemptions from the Investment Company Act. It is not credible that the legislative intent is to exempt from statutory limits relationships with bank-sponsored issuers of asset-backed securities (ABS) who do not make use of these exemptions. This is especially so since ABS issuers can be structured to engage in proprietary trading, as in the case of managed CDOs in which the portfolio manager has discretion to change the underlying collateral.[25]

As discussed in the introductory section above, the statute is intended to increase the stability and security of the financial system by restricting capital market activities of banking entities. During the past decade, it became clear that many banks were conducting large volumes of their capital market activities through relationships with off balance sheet entities that issued asset backed securities. Such entities are the prototypical "shadow banks".[26] The fact that during the crisis banks eventually became liable for many of the liabilities of supposedly free-standing entities that assisted in structuring ABS shows even in cases where sponsoring organizations disclaim any relationship, an implicit affiliation continues to exist.[27]

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[25] Jobst, Andreas A., Collateralised Loan Obligations (CLOs) - A Primer (December 2002). CFS Working Paper No. 2002/13.
[26] Pozsar, Zoltan, Adrian, Tobias, Ashcraft, Adam B. and Boesky, Haley, "Shadow Banking" (July 1, 2010). FRB of New York Staff Report No. 458.
[27] Weil, Jonathan, "Citigroup SIV Accounting Looks Tough to Defend", Bloomberg, October 24, 2007.

Should the Agencies feel that it is necessary to provide a path for particular ABS issuers to function without complying with the full range of Volcker requirements, then such an exemption should be fully justified under the 13(d)(1)(J) pathway for additional permitted activities and should comply fully with the 13(d)(2) safeguards on activities allowed under permitted activities.

Question 13. Are the proposed rule's definitions of buy and purchase and sale and sell appropriate? If not, what alternative definitions would be more appropriate? Should any other terms be defined? If so, are there existing definitions in other rules or regulations that could be used in this context? Why would the use of such other definitions be appropriate?

These definitions are appropriate and should not be further restricted. It is particularly important that any change in derivative terms be defined as a purchase or sale for the purposes of coverage under the rule.

Subpart A – Part 3: Prohibition on Proprietary Trading

Section _3(b)(2)(i): Three-Pronged Test for Trading Account Determination

Under the Proposed Rules, an account is a trading account if it falls within any one of three categories:

1) Any account that is used by a banking entity to acquire or take one or more covered financial positions for the purpose of realizing short-term profits, including arbitrage profits.

2) Any account subject to the market risk capital rule, except for commodity and foreign exchange derivatives and certain commodity futures.

3) Any account used by a banking entity that is a registered securities dealer, swap dealer, or security-based swap dealer to acquire or take positions in connection with its dealing activities.

The breadth of the trading account definition is critical because if positions are excluded from the trading account definition, they will not even be monitored under the Proposed Rule. This is particularly important with respect to positions that benefit from short term price movements through means other than selling, such as arbitrage carry trades. It may be difficult to determine whether short-term arbitrage profits form a significant portion of the return to a position without monitoring some of the same data necessary for oversight of permitted activities. Even positions held longer term need to be monitored for arbitrage profits. Arbitrage trading strategies such as spread, carry, or relative value trades could be easily missed if the provision were construed to focus only on very short term holdings.

The second prong of the trading definition, based on market risk capital coverage, is an extremely positive element of the rule. It offers some assistance with the problem of detecting arbitrage traders as it is generally more beneficial to carry spread or convergence trades on the

trading book. It is also particularly valuable given the historic arbitrage of market risk capital rules and the resulting under capitalization of bank trading books that has been observed.

However, the Agencies indicate that the second prong will be considered as subordinate to the first, and they "do not intend to incorporate 'covered positions' under the market risk capital rules in a way that includes positions lacking short-term trading intent." (footnote 105, CFR 68859). The emphasis on 'short term' is particularly concerning given the Agencies citation of an accounting guidance stating that the term is ''generally measured in hours and days rather than months or years." (CFR 68859). A limitation to an extremely short-term window would be a needless restriction that would greatly limit the effectiveness of the Volcker Rule in capturing some of the riskiest kinds of proprietary trading.

At the least, the second prong should be expanded to capture all positions that are held under the market risk capital rules. To do otherwise would be to risk overlooking important proprietary trades, and a lack of alignment between Volcker Rule coverage and trading book capital treatment would offer additional scope for regulatory arbitrage.

Section _3(b)(2)(ii): Rebuttable Presumption for Certain Positions; Banking Book Securities

Even if the market risk recommendation above is followed, there is still a major issue with available for sale securities held on the banking book for periods in excess of the two month 'rebuttable presumption'. Such securities would allow tremendous scope for putting on arbitrage or spread trades, which can easily be sustained over more than two months.[28] They could be held at mark-to-market/fair value accounting, permitting the booking of arbitrage profits, while clearly constituting a short horizon trading strategy and not a genuine investment. Furthermore, it is possible that one leg of the trade could be executed using the hedging activity permitted under this rule.

As a practical matter, it is useful to have some kind of rebuttable presumption mechanism to better assure compliance given the inherent difficulties in monitoring. However, the holding period for the rebuttable presumption should be substantially extended. The relevant distinction should be between a trader and an investor, as implied by the term "proprietary trader". This is not a distinction that has a consensus definition, but two months is not the proper line. A short holding period will make it very difficult to detect trades intended to reap short-term arbitrage profits, and could also bias regulated banks toward holding positions longer than is prudent to evade oversight under the Proposed Rules. Expanding the rebuttable presumption period, even by a few months, will reduce incentives to put on arbitrage trades, as it will extend the period in which banks will not be able to fully exit positions that have turned against them without triggering oversight provisions for proprietary trading.

To the extent that medium-term holdings of securities on the banking book are intended as a liquidity reserve, then the presence of a broad liquidity exemption granted by the regulators

[28] See Gatev, et. al 2006 finding that the average duration of a profitable open pairs trading position in equities is 3.75 months. Gatev, Evan, Goetzmann, William N. and Rouwenhorst, K. Geert, "Pairs Trading: Performance of a Relative-Value Arbitrage Rule" (2006). The Review of Financial Studies, Vol. 19, Issue 3, pp. 797-827, 2006.

should also address the issue. Thus, the presence of a specific liquidity exemption should also make regulators more comfortable providing oversight for possible proprietary trading in these holdings.

Question 25. How should the proposed trading account definition address arbitrage positions? Should all arbitrage positions be included in the definition of trading account, unless the timing of such profits is long-term and established at the time the arbitrage position is acquired or taken? Please explain in detail, including a discussion of different arbitrage trading strategies and whether subjecting such strategies to the proposed rule would be consistent with the language and purpose of section 13 of the BHC Act.

Arbitrage positions, such as those that brought down Long Term Capital Management and more recently led to enormous losses in 2007 among hedge funds following statistical arbitrage strategies, are classic proprietary trades.[29] They should without question be included under the trading account definition. While arbitrage positions may be held for a long period, they can begin to generate gains and losses in the short run. The direct exposure to capital market prices begins immediately and the strategy only works if the assumed price differential remains steady. It is this, not the potential holding period, that should govern the inclusion of these positions in the trading account. The rule correctly refers to 'realizing short term arbitrage profits' as one aspect of the first prong of the trading account definition. It would be highly problematic if these trades were not covered based on an overly restrictive definition of 'short term' in the trading account or an overly short holding period to trigger the rebuttable presumption of proprietary trading. For a position that is marked to market periodically on the books of the bank, the "term" of the position is the periodicity of the marking. Using this approach, "short-term arbitrage profits" can be identified and measured.

Section _3(b)(2)(iii): Repurchase Agreements And Securities Lending Agreements

The Proposed Rules give a blanket exemption for certain activities from the definition of trading account and therefore the proprietary trading prohibition. Two of these activities are repurchase / reverse repurchase agreements and securities lending. Each involves taking positions that, on their face, are covered financial positions. But under the Proposed Rules, each of these categories of transactions is exempted from the definition of proprietary trading based purely on its form, with no regard to substance

The exclusion of repurchase agreements is expressly founded on the following observation:

> This clarifying exclusion is proposed because positions held under a repurchase or reverse repurchase agreement operate in economic substance as a secured loan, *and are not based on expected or anticipated movements in asset prices*. Accordingly, these types of asset purchases and sales do not appear to be the type of transaction intended to be covered by the statutory definition of trading account. (CFR 68862)

[29] Lowenstein, Roger, When Genius Failed: The Rise and Fall of Long Term Capital Management, Random House, October, 2001. Khandani, Amir E. and Lo, Andrew W., What Happened to the Quants in August 2007?: Evidence from Factors and Transactions Data (October 24, 2008).

If a repurchase agreement is not intended to be a mechanism of realizing profit or loss from asset prices, it would not qualify for trading account designation in any case. In other words, the exclusion is unnecessary. However, the consequences of the exclusion are severe. By deviating from the statutorily mandated scope of permitted activities, the Agencies have opened up massive and unnecessary opportunities for abuse.

The exclusions are solely based on the form of the transactions: repurchase and reverse repurchase agreements and securities lending agreements. This approach is seriously flawed in that it assumes the intent of the parties is defined by the structure of the transaction. However, there are multiple ways that a repurchase or securities lending agreement can be used to place a proprietary trade. Here are a few:

1) Repurchase agreements can permit short-term arbitrage profits when a security pays a return in excess of the repo funding rate available to the bank for that security.[30] This is clearly an arbitrage trade on the spread between the repo and securities market.

2) A securities lending transaction or a reverse repo is generally one leg of a short sale. Whether a security was acquired in a lending transaction or was owned by the bank is the difference between an ordinary sale and a short sale.

3) Repo can be used to synthetically reproduce a forward contract to purchase a bond. Similarly, a forward purchase of a bond can be combined with a repo to synthetically reproduce a current outright bond purchase.[31]

These are just a few examples, and the close similarity between repos and total return swaps suggests that many more could be produced by a clever proprietary trader.

Even beyond these proprietary trading examples, repo requires oversight as a liquidity mechanism. While it is true that a major function of repos is as a financing mechanism, the linkage between repo money markets and securities capital markets is extremely close and immediate. If an asset has a high capital market valuation, this directly increases profits from the use of repo leverage. If asset value drops in the capital markets, the owner can take large and immediate losses through the repo liquidity channel. Most repos are overnight, so repo users are exposed instantly to market price changes for the repo collateral, expressed as changes in margin or haircuts. The unprecedented tightness of the repo connection between asset markets and bank leverage was absolutely central in fueling the credit bubble of 2001-07, as well as the crash of 2007-08.[32] Rising asset values fueled increased leverage through repo, which then further inflated asset values. This created enormous incentives for proprietary profit-taking by banks.

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[30] Salmon, Felix, "What Happened at MF Global", Reuters, November 1, 2011. Choudhry, Moorad, Repo Handbook, Butterworth-Heineman, June, 2002.
[31] Neftci, Principles of Financial Engineering, Elsevier, 2008. See pp. 171-174.
[32] Gary B. Gorton and Andrew Metrick, "Securitized Banking and the Run on Repo," Yale ICF Working Paper 09-14, Nov. 13, 2009; Peter Hördahl and Michael King, "Developments in Repo Markets During the Financial Turmoil," BIS Quarterly Review, Dec. 2008; Also see Comments of Phil Angelides, *Official Transcript of Financial Crisis Inquiry Commission Hearing* on "Shadow Banking System," Day 1, May 5, p. 5.

The drafters of Section 619 did clearly contemplate that bank leverage was an issue that could be addressed within the Volcker Rule. In the detailed colloquy, Senator Merkley stated on the Senate floor[33]:

> "Properly implemented, Section 619's limits will tamp down on the risks to the system arising from firms competing to obtain greater and greater returns by increasing the size, leverage, and riskiness of their trades….Section 619 seeks to reorient the U.S. banking system away from leveraged short-term speculation and toward the safe and sound provision of long-term credit to families and business enterprises"

Repo is a key area where leverage and the principal trading book come together. In this context, regulators have the responsibility to provide oversight through the Section 619 process. This is especially true since regulators themselves have advanced a number of concrete repo reforms that have not yet been implemented. These include through-the-cycle haircuts or margins, restrictions on collateral, and limitations on dependence on overnight repos.[34]

Bringing repo under the scope of Section 619 would not require trade-by-trade oversight. Such oversight could easily be implemented by making repo and securities lending a permitted activity using the 13(d)(1)(J) authority and setting some basic and common-sense rules governing a safe harbor for their use. A broad safe harbor should be created that specifies permissible collateral types, haircuts, and contract terms, and limits the extent of overnight repos as a share of total liquidity. These are not radical reforms; in many ways they would simply return repo to its more conservative past when the underlying collateral was almost exclusively government bonds and some highly rated conventional corporate bonds.[35] The Agencies should take this step.

Section _3(b)(2)(iii): Liquidity Management Exemption

The proposed rule adds an additional liquidity-related exclusion that is not specifically authorized in the statute. This grants the ability to avoid trading account designation for accounts used in the purchase and sale of liquidity related instruments. Rather than the blanket exemption given to repo, in this exclusion the regulators specify that covered financial positions must be obtained "[f]or the *bona fide* purpose of liquidity management and in accordance with a documented liquidity management plan of the covered banking entity". The liquidity management plan must meet five specified criteria.

The addition of the five specified criteria is a significant strength of the liquidity management exemption. If these criteria are given more detail in future regulatory guidance, then they could serve as an effective way to constrain activity under this exemption to genuine liquidity management. For example, liquidity management requirements under Basel III give specific

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[33] Colloquy of Senators Levin and Merkley, Congressional Record, July 15, 2010, p. S5894-S5899, available at http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

[34] Committee on the Global Financial System, "The Role of Margin Requirements And Haircuts in Procyclicality", CGFS Papers Number 36, Bank of International Settlements, March, 2010; Federal Reserve Bank of New York, White Paper: Tri Party Repo Infrastructure Reform, May 17, 2010.

[35] Acharaya, Viral, "The Repurchase Agreement (Repo) Market", in Regulating Wall Street, NYU Stern School of Business, 2011.

definitions of "near term funding needs" and also provide guidance on appropriate liquidity management instruments.

Nevertheless, two questions suggest themselves:

1) Given that there is already an exemption for government bonds and a permitted hedging activity that can address maturity and interest rate mismatches, why is it necessary to add an additional, non-statutory exemption for liquidity management?

2) Why is liquidity management structured as a complete exemption from trading account oversight, rather than as an additional permitted activity under the 13(d)(1)(J) authority to create additional activities? Clearly liquidity management activities will require oversight to ensure that proprietary trading is not taking place.

At a minimum, liquidity management should be structured as a permitted activity under 13(d)(1)(J). This will not only permit oversight under the compliance regime, it will ensure that the 13(d)(2) restrictions on permitted activities apply and the legal authority for enforcing them is not in doubt.

Section _3(b)(3): Covered Financial Positions

The Proposed Rules apply the prohibition to "covered financial positions:"

> any position, including any long, short, synthetic or other position, in:
>
> (A) A security, including an option on a security;
>
> (B) A derivative, including an option on a derivative; or
>
> (C) A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.

The Proposed Rules specifically exclude any position that is:

> (A) A loan;
>
> (B) A commodity; or
>
> (C) Foreign exchange or currency.

The specific exclusion of loans in the Proposed Rules is unnecessary and potentially ambiguous. "Derivative" is defined in the Proposed Rules at _Section __.2(l)(ii)(A) as specifically excluding:

> Any consumer, commercial, or other agreement, contract, or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance, or other action as not within the definition of swap, as that term is defined in section 1a(47) of the Commodity

> Exchange Act (7 U.S.C. 1a(47)), or security-based swap, as that term is defined in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68))….

The term "loan" is defined in the Proposed Rules at _2(q) as "any loan, lease, extension of credit, or secured or unsecured receivable." The use of this broadly defined term as a second exclusion is inappropriate. The CFTC and the SEC have issued proposed rules further defining "swap' and "securities based swap," among other things.[36] These rules and the related discussion constitute an exhaustive analysis, over 82 pages of the Federal Register, of the categorization of derivatives as compared with loans and other contracts. No such in-depth analysis occurs in this rule. The potentially overbroad exclusion of all loans should be abandoned in favor of reliance on the further definition of swaps and security-based swaps by the CFTC and the SEC.

Furthermore, the Proposed Rules exclude "a commodity" and "foreign exchange and currency." Thus, at least some traditional foreign exchange swaps in which one counterpart agrees to exchange a quantity of currency in exchange for a quantity of another currency and commodity purchases and sales may not be covered transactions. Yet in the rule overview the Agencies provide the following explanation of the scope of "covered financial positions:"

> This term is used to define the scope of financial instruments subject to the prohibition on proprietary trading. Consistent with the statutory language, such covered financial positions include positions (including long, short, synthetic and other positions) in securities, derivatives, commodity futures, and options on such instruments, ***but do not include positions in loans, spot foreign exchange or spot commodities***. (CFR 68850; Emphasis added).

This is a fair description of the definition. However, the exclusion actually contained in ___.03(b)(3)(ii) of the Proposed Rules is not explicitly limited to spot transactions, instead excluding "any position that is… a commodity (or) foreign exchange or currency." The Proposed Rules must be amended to conform to the Agencies' intent as described in the above-quoted language and specify spot commodities and foreign exchange.

Subpart A, Part _4: Permitted Activities in Underwriting and Market-Making

It is of major importance that the Agencies ban illiquid and opaque securities with no genuine external market from being traded under the underwriting and market making exemptions. As discussed below, such 'mark to model' securities cannot fit the traditional definitions of underwriting and market making, which rely on selling a security for a predictable price into a known market. In addition, the metrics-based compliance regime proposed in this rule for oversight of permitted activities loses a great deal of its effectiveness when it is applied to such securities. When valuations are determined by an internal model and not by observable market prices, it is easy to manipulate the model to produce valuations that satisfy the metrics regime.

As a practical step to implement this restriction, in the discussion below we suggest banning market making and underwriting for assets classed as Level 3 under SFAS 157.

[36] 76 Federal Register 29918.

Section _4(a): Underwriting

The statutory basis for this exception is as follows (in 13(d)(1) of the BHC):

> Notwithstanding the restrictions under subsection (a)… the following activities… are permitted: [t]he purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) in connection with underwriting activities, to the extent that any such activities… are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.

This concept closely matches the traditional definition of underwriting. That is, the bank is acting as a principal to buy and sell client-issued securities into existing markets in response to the near term demands of clients who wish assistance in securities issuance. The key element is that the permitted activity facilitates pre-existing client demand. It is important to see that this statutory definition does not match certain types of 'underwriting' that frequently took place during the credit bubble. During this period, banks, on their own initiative, designed and structured complex and novel new types of instruments with no pre-existing market, and then sought out customers for the transaction while retaining part of the issuance on their own books.[37] Although these transactions were frequently referred to as private placement underwritings, they stray from both the traditional definition of underwriting and the statutory description of the activity.

The Agencies provide further guidance as to underwriting activities:

> Under the proposed rule, the underwriting activities of a banking entity must be *designed to generate revenues primarily from fees, commissions, underwriting spreads or other income, not from appreciation in value of covered financial positions* that the banking entity holds related to such activities or the hedging of such covered financial positions. This proposed requirement should promote investor confidence by ensuring that the activities conducted in reliance on the underwriting exemption are designed to benefit the interests of clients seeking to bring their securities to market, not the interests of the underwriters themselves. [CFR 68925, emphasis added.]

The quoted language is completely consistent with the well-understood concept of underwriting and with the fundamental purpose of Section 619. Banking entities can engage in underwriting activities that assist clients and are undertaken in the context of reasonable predictability of the financial outcome to the banking entity and the client. The reasonable expectation is that the banking entity will earn the underwriting discount. For this to be true, there must be a discernible and sufficiently liquid pre-existing market for the securities being distributed, and the securities must be sold into that market at a price that is foreseeable.

The final rules must maintain these principles. There are several important issues:

[37] Dunbar, Nicholas. *The Devil's Derivatives*. Boston, Massachusetts: Harvard Business Review Press, 2011

Distribution of Opaque, Novel, and Illiquid Securities. If a new product launched without a pre-existing market, the financial results to the banking entity are unknown. The banking entity may have designed the activity to encourage participation of buyers and sellers for the security because it wishes to underwrite subsequent offerings of that type. However, the banking entity has no reasonable basis for forecasting the outcome of the activity. It has taken a position in the securities for a business purpose: to create a market for future activity. However, this is not underwriting and must be subject to the other provisions of Section 619. If this result is not the rule, the banking entity could use activity that has the trappings of an underwriting to create a proprietary risk that evades the meaning of Section 619. As a first step, the Agencies should ban underwriting activities for assets classified as Level 3 in the FAS 157 fair value hierarchy. Note that this would simply prevent underwriting exposures to instruments the Agencies themselves classify as "high risk assets", which are defined in Appendix C (CFR 68964) as "assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated".

Retained securities: It is extremely important that securities obtained under the underwriting exemption be rapidly and completely disposed of. While a small portion of an underwriting may occasionally be "hung", the systematic retention or warehousing of underwritten securities on the bank's own books is a clear indication that the bank intended the underwriting as a proprietary transaction. This is obviously particularly dangerous in the case of opaque and illiquid securities. It was exactly this practice that led to massive losses for major banks during the financial crisis.[38] Banks should not be able to profit through large-scale retention of securities obtained under the underwriting exemption. As discussed below, this principle should be incorporated into the compensation and metrics rules for underwriting.

Selling Group Members. The Proposed Rules depart from the SEC's Reg M definition of underwriting by allowing selling group members to take advantage of this exception so as to "permit the current market practice of members of the underwriting syndicate entering into an agreement with other selling group members to collectively distribute the securities, rather than requiring all members of a distribution to join the underwriting syndicate." It is simply inaccurate to say that, without this expansion of the SEC definition, the law would require all members of a distribution to join a syndicate. Rather it means that a banking entity that is a selling group member, merely getting a price concession from an underwriter, could not qualify its principal activity under the underwriting exception. There is no justification for the expansion of the exception to include selling group members who are providing no price guarantee to the issuer. No service to a customer is involved. The final rules must make it clear that being a selling group member is not "underwriting" for the purposes of the exemption.

Structured Financings. In the case of the creation of structured instruments, the question is: Who is the client that is seeking to bring its securities to market? The existence of a special purpose vehicle or other 'intermediate entity' that serves as a structuring device so that securities can be issued is not a sufficient answer. Such an intermediate entity is not a customer. The question is whether the interests served are substantively the banking entity's as opposed to an external client who wishes to bring a new security to market. If the banking entity is the driver of the demand, then the banking entity is acting as the principal and is not serving near term demands

[38] UBS AG, Shareholder Report on UBS Write Downs, April, 2008.

of clients, customers, or counterparties, as required by the Dodd-Frank Act. This does not prevent the banking entity from raising capital from assets that it holds. But it does mean that the underwriting exception cannot be a mechanism to enable the banking entity to engage in proprietary trading under the guise of the underwriting exception. The banking entity would need to be the client of another entity that provides underwriting services.

Question 73. How accurately can a banking entity engaging in underwriting predict the near-term demands of clients, customers, and counterparties with respect to an offering? How can principal risk that is retained in connection with underwriting activities to support near-term client demand be distinguished from positions taken for speculative purposes?

As stated in the agencies own analysis quoted above, the underwriting permitted activity is intended to assist clients in bringing securities to market. There should thus be a two-way client demand in the case of this exemption; clients who wish assistance in marketing their securities and customers who may wish to purchase those securities. The bank should serve an intermediary function. Unlike in the case of the market-making exemption, the bank should not have to retain principal risk on its books in anticipation of future customer demands that are unrelated to a specific underwriting the bank has performed at the request of a client. In contrast, the bank would take down securities from the syndicate account on a near "just in time basis." Balances during the underwriting process should be low. As stated above, if it is genuinely performing an underwriting role the bank should try to rapidly sell underwritten securities off its books.

Question 75. Is the requirement that the compensation arrangements of persons performing underwriting activities at a banking entity be designed not to reward proprietary risk-taking effective?

The inclusion of compensation guidelines in each permitted area is a positive and valuable step. However, the principle stated is highly general and it would be helpful to tailor compensation arrangements more specifically to each permitted activity. In the case of underwriting, this could be done by ensuring that personnel involved in underwriting are given compensation incentives for the successful distribution of securities off the firm's balance sheet, and are not rewarded for profits associated with securities that are not successfully distributed. (Losses related to undistributed securities should, however, be taken into consideration). Bonus compensation for a deal should be withheld until either all or a very high percentage of securities allocated during the underwriting are distributed.

_Section 4(b): Market Making

The Agencies provide their analysis of the rationale of Congress for excluding market making.

> [T]he purpose and function of these two activities are markedly different – market making-related activities provide intermediation and liquidity services to customers, while proprietary trading involves the generation of profit through speculative risk-taking…." (CFR 68869)

Yet drawing distinctions between the market making (and other excepted activities) and proprietary trading two in the context of daily trading activity is very difficult:[39]

> These permitted activities – in particular, market making, hedging, underwriting, and other transactions on behalf of customers – often evidence outwardly similar characteristics to proprietary trading, even as they pursue different objectives…

As a result, analysis of the exceptions focuses primarily on identification of the important objective characteristics of the excepted activity and the methods for observing that the activity claimed to be excepted exhibit those characteristics.

The Agencies implementation of Section 619's exception for market making must be guided by the intent of Congress. This is best articulated by Senator Merkley in the debate on this provision:

> Market-making is a *customer service whereby a firm assists its customers by providing two-sided markets for speedy acquisition or disposition of certain financial instruments.* Done properly, it is not a speculative enterprise, and revenues for the firm should largely arise from the provision of credit provided, and not from the capital gain earned on the change in the price of instruments held in the firm's accounts. Academic literature sets out the distinctions between making markets for customers and holding speculative positions in assets, but in general, the two types of trading are distinguishable by the volume of trading, the size of the positions, the length of time that positions remains open, and the volatility of profits and losses, among other factors….Vigorous and robust regulatory oversight of this issue will be essential to the prevent ``market-making'' from being used as a loophole in the ban on proprietary trading. [Emphasis added.][40]

In Section _4(b)(2) the Proposed Rules establish six criteria in defining market making. Below is a detailed discussion of three of these criteria.

Bona Fide Market Making. Of particular importance is the second criterion, that the activity be "bona fide market making." Under this criterion, the Agencies explicitly rely on the existing definitions of "market maker" in the Securities Exchange Act of 1934:

> [A]ny specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer quotation communications system or

[39] Financial Stability Oversight Council, "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds," January 2011 (herein referred to as the "Study"), page 2.

[40] Congressional Record, 111th Congress, page S5896.

otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.[41]

The SEC's implementing rules are also instructive, though not discussed in the NOPR:

> The term "Qualified OTC Market Maker" in an over-the-counter ("OTC") margin security means a dealer in any "OTC Margin Security" who …except when such activity is unlawful, meets all of the following conditions with respect to such security:
>
> 1. He regularly publishes bona fide, competitive bid and offer quotations in a recognizable inter-dealer quotation system;
>
> 2. he furnishes bona fide, competitive bid and offer quotations to other brokers and dealers on request,
>
> 3. he is ready, willing and able to effect transactions in reasonable amounts, and at his quoted prices, with other brokers and dealers, and
>
> 4. he has a reasonable average rate of inventory turnover in such security.[42]

Although the Agencies cite the relevant concepts in defining market making, they then proceed to ignore many of them. The quoted language is very clear that "making" a "market" means that the entity makes available price quotes at levels at which the entity is at the same time willing to both buy and sell. Further, the activity must be bona fide, demonstrated by (1) the regularity of publication of quotes, (2) the competitiveness of quotes, (3) being ready, willing and able to effect transactions at the quoted prices in reasonable amounts and (4) maintaining inventory turnover rates in reasonable average amounts.

Embedded in these concepts is a precondition: the securities must be transacted in a market in which bid and ask price levels exist. One way to think of this is that, in the absence of regularly available bid/ask spreads, no market has been made by the entity purported to be a market maker or by anyone else. Said another way, there is no market. This is the only reasonable interpretation of the concept used by Congress in section 619.

Certain individual securities may be somewhat illiquid but can be still reliably valued with reference to other, extremely similar securities that are regularly traded in liquid markets. As example might be a corporate bond with an unusual maturity, but which is otherwise closely analogous to other corporate bonds from similar issuers for which recent price data is available.[43] This would allow the financial outcome from dealing to be reasonably predictable and thus

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[41] Securities Exchange Act, Section 3(a)(38).

[42] SEC Rule 3-B(8).

[43] Such securities are sometimes classified as "Level 2" under the FAS 157 guidance, and are contrasted with "Level 3" securities for which no external price guidance exists and pricing is model-reliant.

market making could be permitted. It is critical, however, that the basis for this standard be an external, transaction based set of data, rather than a valuation made by an internal source or an external index based on valuation models rather than actual transactions.

The approach taken in the Proposed Rules is far broader than what could be justified under Section 619. At certain places in the rule, the Agencies appear to verge on a definition that equates market making with hedging – if something is hedged, the motivation must be market making. This is beyond the scope of Section 619. Profiting from the creation of entirely customized exposures for a client by betting on the spread which may or may not be realized on a hedge can give rise to activities of almost unlimited complexity that are far removed from capital provision to the real economy. Furthermore, a simple equation of market making with hedged positions will make it difficult to control the use of market making to put on arbitrage or spread trades.

The Agencies describe legitimate market making in Appendix B (CFR 68960):

> The primary purpose of market making-related activities is to intermediate between buyers and sellers of similar positions, for which service market makers are compensated. . . . The *purpose of such activities is not to earn profits as a result of movements in the price of positions* and risks acquired or retained; rather, a market maker generally manages and limits the extent to which it is exposed to movements in the price of principal positions and risks that it acquires or retains, or in the price of one or more material elements of those positions. [Emphasis added.]

The Agencies express a view that is reasonably consistent with this common meaning in connection with liquid covered financial positions (CFR 68870):

> In the context of relatively liquid positions, such as equity securities or other exchange-traded instruments, a trading desk or other organizational unit's market making-related activity should generally include:
>
> - Making continuous, two sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
>
> - A pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;
>
> - Making continuous quotations that are at or near the market on both sides; and
>
> - Providing widely accessible and broadly disseminated quotes.

Notably, these factors omit some elements needed to establish *bona fide* market making, such as willingness to transact in reasonable quantities at quoted prices and inventory turnover. These

are discussed in the context of factors that should be monitored; but they should be addressed directly in the definition as well. However, the enumerated factors are otherwise reasonably consistent with the established concept of market making.

Unfortunately, the Agencies expressly contemplate that the market making exception applies to activities that are simply inconsistent with the meaning of the concept (CFR 68871):

> In less liquid markets, such as over-the-counter markets for debt and equity securities or derivatives, the appropriate indicia of market making-related activities will vary, but should generally include:
>
> - Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;
>
> - With respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market; and
>
> - Transaction volumes and risk proportionate to historical customer liquidity and investments needs.

As a threshold matter, this language is fundamentally inconsistent with market making. It contemplates that only taking one side of the market – being a buyer ***or*** a seller -- is sufficient. It must be changed to require two-sided activity in order to conform to Congress's intent as illustrated by the comments of Senator Merkley quoted above.

The market maker must both purchase and sell the same financial instrument. In their colloquy, Senators Levin and Merkley explained this[44]:

> "Testimony by Goldman Sachs Chairman Lloyd Blankfein and other Goldman executives during a hearing before the Permanent Subcommittee on Investigations seemed to suggest that any time the firm created a new mortgage related security and began soliciting clients to buy it, the firm was "making a market" for the security. But one-sided marketing or selling securities is not equivalent to providing a two-sided market for clients. The reality was that Goldman Sachs was creating new securities for sale to clients and building large speculative positions in high-risk instruments, including credit default swaps. Such speculative activities are the essence of proprietary trading and cannot be properly considered within the coverage of the terms "market making."

[44] Colloquy of Senators Levin and Merkley, Congressional Record, July 15, 2010, p. S5894-S5899, available at http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

Market makers must demonstrate that their activity on both sides of the market is *bona fide*, optimally exhibiting a proportion of long and short transactions that are close to being balanced.

Far more troubling is the statement in footnote 149 accompanying the above-quoted language at CFR 68871: "The frequency of such regular quotations will itself vary; less illiquid markets may involve quotations on a daily or more frequent basis, *while highly illiquid markets may trade only by appointment*." [Emphasis added.] This approach was presaged in the Study:

> For example, in the case of over-the-counter derivatives markets, which are structured differently from liquid securities markets, market making typically entails a customer-initiated transaction involving a bespoke financial instrument. The trading desk provides the customer with a price and upon execution will hold the financial instrument in its portfolio. As these are customized derivatives, they do not typically have a matching offset (i.e., matched book). The market making desk will typically dynamically hedge to offset the exposures.[45]

No doubt, banking entities have in the past commonly taken a complex position for which there is no market and then "dynamically hedged" it. This, of course, is not market making. It is rather speculating on the potential profit embedded in the risk differential between the underlying position and the dynamic hedge (which is in fact a mechanism for defining the speculative risk to which the banking entity seeks to expose itself motivated by the opportunity for proprietary profit). It is unfortunate that the term "dynamic hedge" implies to the Agencies benign risk management, obscuring its clear purpose.

The Agencies approach described above is fundamentally at odds with the fifth criterion of the definition of market making regarding revenue from the activity (CFR 68872):

> Under § __.4(b)(2)(v) of the proposed rule, the market making-related activities of the banking entity must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions it holds in trading accounts or the hedging of such positions. This criterion is intended to ensure that activities conducted in reliance on the market-making exemption demonstrate patterns of revenue generation and profitability consistent with, and related to, the intermediation and liquidity services a market maker provides to its customers, rather than changes in the market value of the positions or risks held in inventory.

A position for which there is no readily discernible exit price cannot be said to have been entered into based on the revenue motivation outlined above. First, there is no bid/ask spread or other reliable reference valuation based on objective transaction data. Second, if some fee or commission is explicitly charged, it cannot be known what relationship it bears to the full anticipated profit or loss on the position. Reasonable predictability of the financial outcome

[45] Study at page 20.

from engaging in the transaction is a fundamental characteristic of market making as opposed to proprietary speculation.

As a way to prevent evasion of the rule, we have two recommendations to the Agencies:

First, the rule should ban market making for assets classified as Level 3 in the FAS 157 fair value hierarchy. Clearly no market exists in an asset which cannot be valued even indirectly using observable data, and it is inappropriate for market-making. Note that this would simply prevent underwriting exposures to instruments the Agencies themselves classify as "high risk assets", which are defined in Appendix C (CFR 68964) as "assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated". This approach would still allow market making in conventional but rarely traded instruments, such as some corporate bonds. These can generally be valued using inputs from comparable instruments that have traded in the market recently.

Second, the agencies should specify the treatment of "bespoke" or "customized" derivatives. Such instruments should be disaggregated into liquid risk elements and illiquid risk elements. Market making could take place for liquid risk elements but illiquid risk elements would have to be traded under the exception for riskless customer transactions.

As a further explanation of the second recommendation above, any derivative is best understood as an amalgam of elemental risks. In these transactions, banking entities serve their customers by assembling these risks in a single contractual instrument which aligns with the specific risks in a given business undertaking. In a given "bespoke" derivative contract, some of these risks correspond to more standardized derivatives for which there are markets. That is, there are substantial trading venues in which long and short prices for these standardized exposures are quoted reasonably continuously. These can be thought of as the "liquid risk elements", generally standardized, exchange-traded derivative exposures. For the other, "illiquid risk elements," there are no such venues. The related hedging activity typically engaged in by the banking entities illustrates this configuration.

The market making exception should be implemented with this in mind. By taking this approach, implementation of the exception would reflect the way that trading entities actually view these risks. Liquid risk elements could be transacted under the market making exception in a way that does not distort the fundamental meaning of market making. As discussed above, the market-making definition does permit trading in such instruments. However, the purchase of illiquid or customized risk elements is not permitted under the market making exemption and should instead be arranged through non-bank third parties such as hedge funds. The bank could do this under the exception for relatively riskless customer transactions, outlined at Section _6(b)(2)(ii) in the Proposed Rule.

The end user customers of banking entities need not forego the convenience of complex, multi-risk derivatives (though the prudence of entering into such illiquid and opaque arrangements is a matter of some considerable doubt). The transaction could be made administratively seamless from the customer perspective. However, the banking entities would be required to properly

disaggregate the risks and potentially justify the transaction using multiple exceptions. Illiquid or customized risks would not be held on the bank's own books. Without this step, there would be a large incentive to use complex transactions to avoid the proprietary trading prohibition.

Question 97. Is the requirement that the compensation arrangements of persons performing market making related activities at a banking entity not be designed to encourage proprietary risk-taking effective? If not, how should the requirement be changed?

The inclusion of compensation guidelines in each permitted area is a valuable element of the rule. However, the principle stated is highly general and it would be helpful to tailor compensation arrangements more specifically to each permitted activity. In the case of market making, a straightforward, yet powerful, means of ensuring that compensation mechanisms discourage proprietary risk taking would be to require that salaries are not symmetrical between gains and losses and that trading gains that reflect an unusually high variance in position values are either not reflected or less reflected in compensation and bonuses. This will provide traders an incentive to adopt the risk aversion characteristic of market makers.

As in underwriting compensation, it would also be very helpful to withhold any bonus for profits associated with an instrument until that instrument is no longer in inventory and is completely off the bank's books. This would give traders incentives to do the two sided market making required in the statute and would avoid inventory buildup.

Question 99. Should the terms ''client,'' ''customer,'' or ''counterparty'' be defined for purposes of the market making exemption? If so, how should these terms be defined? For example, would an appropriate definition of ''customer'' be: (i) A continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction; (ii) a direct and substantive relationship between the banking entity and a prospective customer prior to the transaction; (iii) a relationship initiated by the banking entity to a prospective customer to induce transactions; or (iv) a relationship initiated by the prospective customer with a view to engaging in transactions?

The statutory definition of proprietary trading refers to "engaging as a principal" in certain types of trading. The counterpoint to this concept is business activity that is focused on serving the interests of other entities, such as customers and clients, in return for compensation.

Even though these concepts are central to all elements of Section 619, the Agencies elected not to define formally the terms "customer" or "client" in the definitions section of the Proposed Rules, despite using the terms frequently throughout the NOPR. Here, the Agencies ask whether terms such as ''client,'' ''customer,'' or ''counterparty'' merit definition for purposes of market making. The answer is an emphatic "yes," but the applicability of these definitions must be far broader than market making.

The concept of a customer figures importantly for banking entities, which, after all, serve customers. Indeed, the statute reshapes the relation between banking entities and customers by prohibiting proprietary trades that may profit the firm at the expense of their own customers.

Major exceptions including market making, underwriting and customer transactions are defined by the customer-oriented motive behind the banking entity's activity. The statute further bans circumstances where the firm stands in conflict with the interests of customers. A clear definition of a customer, then, is imperative.

The bank, or a covered fund, or a bank employee, may not be a "customer." Chairman Volcker explained, "When the bank itself is a "customer", i.e., it is trading for its own account, it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank. "Inside" hedge funds and equity funds with outside partners may generate generous fees for the bank without the test of market pricing, and those same "inside" funds may be favored over outside competition in placing funds for clients. More generally, proprietary trading activity should not be able to profit from knowledge of customer trades."[46]

Generally, the concept of the customer and client should be understood as the person or institution served by the banking entity. The *bona fide* market maker or underwriter should be acting in response to customer or client demand, rather than initiate transactions. Initiating transactions is an indicator of proprietary trading. A customer or client must be defined using a combination of items (i) and (iv) in the question above. That is, a customer is either an unaffiliated person or institution with a preexisting continuing relationship during which the banking entity has provided one or more financial products (customers) or services (clients) prior to the time of the transaction, or alternatively for a new customer a relationship initiated by the prospective customer with a view to engaging in transactions. The Agencies footnoted discussion (Footnote 199) of customers generally hews to this concept of a customer determining the action of the banking entity. However, elastic use of the term, such as defining a customer as "any person on behalf of whom a buy or sell order has been submitted by a broker-dealer" opens the possibility that the person could be the banking entity itself.

Importantly, the Agencies must describe activities that are not based on customer or client relationships. For example, a banking entity that originates a financial product and then finds a counterparty, either by initiating contact or by inviting expressions of interest, should not be viewed as serving customer interest, and therefore should not be considered to be engaging in underwriting or market making. Employees of a banking entity engaging in such activity is acting as sales agents, not market makers or underwriters. Moreover, transactions with entities that may be customers or clients in certain contexts that are driven by algorithmic trading strategies should not be considered to be in service of the customer or client.

As a practical matter, the ability to manage inventory through inter-dealer transactions should be accommodated. A condition must be that the inventory must be at an appropriate level after completion of the transaction. If the inter-dealer transaction is between two institutions covered

by Section 619 proprietary trading provisions, each would be responsible for compliance with this principle. It could be implemented in a "customer" definition, providing that such transactions are an element of the customer business, or by a free-standing provision. Compliance would be a trivial matter. Activity that does not comply is clearly outside the market making business.

Subpart A Part _5: Risk-Mitigating Hedging

Hedging is one of the most difficult permitted activities to oversee under the Volcker Rule. Unless it is possible to require perfect hedges, basis risk will be created that is very difficult to distinguish from proprietary spread or basis trading. Because hedging by its nature creates low-volatility profits so long as historical correlations and relationships remain constant, many of the quantitative metrics will be less effective in spotting proprietary trading under the hedging activities.

In addition, the generalized hedge exemption is particularly susceptible because it can be applied to any bank asset, including those that are not held in trading accounts. Thus, a bank can purchase assets for its banking book free of any Section 619 restrictions, and then put on a hedge and (if supervision is not adequate) execute a spread or arbitrage trading strategy using that hedge. The ability to freely choose the asset to be hedged opens up many trading strategies.

A number of specific changes will strengthen oversight of hedging activities:

1) Regulators should place careful bounds on the interpretation of hedging "aggregated" risks to avoid portfolio hedging. Aggregation should refer to specific netting procedures reflected in a documented hedging policy.

2) The requirement of "reasonable" correlation should be strengthened to "strong" or "high" correlation and should be tested in stressed markets.

3) The requirement that a hedge not add new incremental risk at inception should be given priority and applied to risks that emerge later but were predictable at inception.

4) The agencies should consider the use of additional capital charges for significant levels of basis risk that accumulate under the hedge exemption.

5) The hedge exemption should be targeted for intensive monitoring to ensure that it does not become a profit center. This should be reinforced in compensation rules.

Hedging will still remain a challenging area for oversight.

The Dodd-Frank Act specifically permits certain hedging activity that would otherwise be prohibited as proprietary trading (Section 13(d)(1)(C) of the BHC Act):

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[46] Statement of Paul A. Volcker Before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, Washington, DC, February 2, 2010.

> Notwithstanding the restrictions under subsection (a).., the following activities… are permitted: Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.

The elements of this provision are important.

- It addresses trading activity that would otherwise be subject to the proprietary trading prohibition (that is to say, that the positions are in a trading account),
- And are designed to reduce the specific risks to the banking entity in connection with and related to positions contracts or other holdings,
- And is risk-mitigating.

It is abundantly clear that the purpose of the activity is the important focus. The transactions must be risk reducing, in fact as well as in design.

The scope of the hedging exemption in the Proposed Rules is not identical to the statute.

> The purchase or sale… [h]edges or otherwise mitigates one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity….[47]

Of particular note is the use of hedging and risk mitigation in the disjunctive. Section 619 uses risk mitigation to further define or narrow 'hedging.' In the final rules, the definition must be reconciled with the statute.

The mention of aggregated positions in the statute must not be interpreted as a license for unlimited portfolio hedging. It would utterly undermine the legitimate use of the hedge exemption if it was possible to use proprietary activity at one desk as a theoretical 'hedge' for proprietary activity at another desk (e.g. a short position in oil as a hedge for a long position in equities). The drafters of the statute specifically warned of this[48]:

> "purchasing commodity futures to 'hedge' inflation risks that may generally impact the banking entity may be nothing more than proprietary trading under another name"

The use of 'aggregation' should be carefully limited to a specific position that is netted with another position through data systems that routinely net positions as part of high-quality internal

[47] Proposed Rules, Section 5(b)(2).
[48] Colloquy of Senators Levin and Merkley, Congressional Record, July 15, 2010, p. S5894-S5899, available at http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

risk management. Such netting practices should also be pre-specified in written hedging policies and procedures.

It is unclear whether either the regulators or the banks themselves have a reliable mechanism for accurately measuring and aggregating risks across the entire bank. This underlines the importance of tying aggregation of positions to specific netting procedures.
In line with the statutory reference to "specific risks", desk-level hedging of specific trading risks should be favored. General portfolio hedging should not be allowed outside of a specific netting procedure as described above, but if any general portfolio hedging does become necessary this should be an indicator that hedging by desk traders is not being properly performed.

There are a variety of restrictions on hedging in Section _5(b)(2). These include:

1) The hedge must be performed in alignment with written policies and procedures.

2) The hedge must be tied to a "specific risk".

3) The hedge must be 'reasonably correlated', based on the 'facts and circumstances' to the risks intended to be mitigated.

4) A hedge should "not give rise, at the inception of the hedge, to significant exposures that were not already present".

5) Section 5(b)(2)(v) sets out a 'continuing review' process for dynamic hedging. The standards do not explicitly state the protection that the hedge should not give rise to new risk exposures.

This is a reasonable list but it should be both strengthened and clarified.

First, the 'reasonable correlation' requirement given in _5(b)(2)(iii) should be strengthened. The word 'reasonable' should be replaced by "strong".

In addition, the concept of correlation should be expanded by being connected to real economic relationships and made durable to stressed market correlations. Correlation must be founded in objective real world economic relationships. The mathematical relationships can only be used to the extent that the logical relationship underlying price movements can be demonstrated.

In addition, correlations, which are based on historic data, must be tested using assumptions that go beyond historic precedents. For example, market baskets of securities prices might be used as a hedge. The hedge is structured based on an observed level of internal negative correlation among the constituents in the market basket. However, as demonstrated in the financial crisis, under severe market stress conditions, the negative correlations break down as all prices move in concert. As a result the hedge is dangerous in precisely the conditions in which hedging is most important. Stress testing using extreme but plausible (*i.e.*, unprecedented) conditions must be used to evaluate the reasonableness of correlations.

In addition, the 5(b)(2)(iv) requirement that a hedge should not give rise to significant

incremental new exposures should be made as concrete as possible.

For an illustrative example of how this could be done, consider the problem of hedging a long swap on the June 2012 price of natural gas delivered at the Houston Ship Channel. As background, natural gas at Houston Ship Channel is sourced at the Henry Hub so that the price of natural gas delivered at the Houston Ship Channel is the Henry Hub price plus pipeline transmission costs and factors wholly related to the delivery at the Houston Ship Channel. The Houston Ship Channel position is actually a composite of two positions: Henry Hub and the basis differential between Henry Hub and the Houston Ship Channel. Suppose the banking entity hedged by entering into a short swap on the price of natural gas delivered at the Henry Hub during June 2012. That hedge would fully satisfy the 5(b)(2)(iv) restriction that no risk is added to the original position. Basis risk does remain, but it is a risk that represents a constituent element of the original position.

Alternatively, the Houston Ship Channel position could be hedged by a short Henry Hub swap on prices for the third quarter of 2012. The June price embedded in the Henry Hub swap would offset the June Houston Ship Channel swap. But the July and August prices embedded in the Henry Hub swap would not. As a result, the third quarter Henry Hub swap would add additional economic risk to the June Houston Ship Channel swap. This additional economic risk has an effective element of proprietary trading. As another example, the banking entity could enter into a short South Texas power swap for June 2012. This power swap price would be highly correlated to natural gas prices since marginal power is generated in that region using natural gas as a fuel. Therefore, to the extent of the correlation, the Houston Ship Channel position risk would be reduced. However, the banking entity would also be taking on an additional risk, that is, the basis risk between power prices and natural gas prices in South Texas. Unlike the case of the Henry Hub swap, the remaining risk would be newly created. The purported hedge would be "non-congruent" with the hedged position and would create incremental risk.

The potential for adding incremental risk and essentially doing a proprietary trade on basis risk is by no means limited to physical price derivatives. A purported hedge that embeds optionality terms that are not congruent with the "hedged" position is conceptually the same. The "hedged" position and the "hedging" position might be highly price-correlated until the market price causes the optionality term to "kick in." At that point, the positions would no longer be correlated and the banking entity would experience the consequences of a wholly new risk. This concept is consistent with the Agencies' position as articulated in the discussion of 5(b)(2)(iv) on CFR 68876. Such incremental risk should be looked at with suspicion even if correlations are high.

In interpreting the dynamic hedging review process under 5(b)(2)(v) of the rule, it is important to understand that the new risks generated by both the power price "hedge" and the "hedge" with the embedded option did not spring into existence when the consequences were experienced by the banking entity. The risks existed at the inception of the purported hedges. Every trader would think of it the same way. They took on the power/natural gas basis risk or the optionality risk when the trade was executed. In other words, in most cases the appearance of additional risk during the review process for a dynamic hedge retroactively reveals a violation of the congruency principle in 5(b)(2)(iv). The Agencies discuss this issue:

> "In addition, proposed § __.5(b)(2)(iv) only *requires that no new and significant exposures be introduced at the inception of the hedge, and not during the entire period that the hedge is maintained, reflecting the fact that new, unanticipated risks can and sometimes do arise* out of hedging positions after the hedge is established. The Agencies have proposed to address the appropriate management of risks that arise out of a hedge position after inception through § __.5(b)(2)(v) of the proposed rule. [CFR 68876, Emphasis Added.]

In this case, the idea of new risks arising after inception should be limited to entirely new risks that were not foreseeable at hedge inception. This should be contrasted with an incremental embedded risk existing at the inception of the purported hedge. These risks do not arise nor are they unanticipated at inception. They in fact give rise to new risks at inception and constitute proprietary trading.

The Agencies' discussion of the sixth criterion includes the following statements related to the requirement that hedges be subject to review:

> Such review, monitoring, and management must: (i) be consistent with the banking entity's written hedging policies and procedures; (ii) maintain a reasonable level of correlation, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and (iii) mitigate any significant exposure arising out of the hedge after inception.

It should be made clear that the management and monitoring requirement does not mean that incongruent hedges with incremental risks embedded at inception are fully permissible so long as they are monitored and managed.

The Agencies also refer to the concept of "dynamic hedging," (CFR 68875):

> In addition, this criterion [three] would include a series of hedging transactions designed to hedge movements in the price of a portfolio of positions. For example, a banking entity may need to engage in dynamic hedging, which involves rebalancing its current hedge position(s) based on a change in the portfolio resulting from permissible activities or from a change in the price, or other characteristic, of the individual or aggregated positions, contracts, or other holdings. The Agencies recognize that, in such dynamic hedging, material changes in risk may require a corresponding modification to the banking entity's current hedge positions.

If the risk changes result from changes to the hedged portfolio (for instance, from increased internal netting within the portfolio), the hedges must be recalibrated. However, if the dynamically managed risks are extant at the inception of the "hedge," that transaction was not a hedge in the first place but a prohibited proprietary trade. This should be made clear.

Finally, as discussed further in the metrics section below, a specific metric for hedging should be added to track realized profits on hedging activities. If such activities are steady profit generators this could be an indicator of arbitrage trading.

Question 110. Is the requirement that the transaction be reasonably correlated to the risk or risks the transaction is intended to hedge or otherwise mitigate effective? If not, how should the requirement be changed? Should some specific level of correlation and/or hedge effectiveness be required? Should the proposal specify in greater detail how correlation should be measured? Should the proposal require hedges to be effective in periods of financial stress?

A pure correlation metric needs to be supplemented by some judgment of a real economic relationship between the hedging position and the position to be hedged. Historical correlations can fail when they do not represent real relationships. The discussion above gives further detail.

Question 113. Is the requirement that the compensation arrangements of persons performing risk-mitigating hedging activities at a banking entity be designed not to reward proprietary risk taking effective? If not, how should the requirement be changed?

The inclusion of compensation guidelines in each permitted area is very valuable. However, the principle stated is highly general and it would be helpful to tailor compensation arrangements more specifically to each permitted activity. Since risk-mitigating hedging is designed to keep a net position as close as possible to risk-free, profits on a net position (the combined returns of the hedge and the hedged position) should not be rewarded in compensation. Instead, losses should be penalized and excessive profits should be penalized as well, as they likely represent an addition of risk to the position. In addition, like other compensation incentives, traders should not be rewarded for a hedge until the hedge is wound up and leaves the bank's books.

Section _6: Other Permitted Proprietary Trading Activities

Section 619 establishes a number of exceptions of proprietary trading activities from the general prohibition. Certain of these relate to the nature of the covered financial positions or the banking entity: trading in certain government obligations and trading by certain foreign entities outside of the US and by regulated insurance companies on behalf of insurance clients.

Permitted Trading In Government Obligations

The exception related to the obligation of States and their political subdivisions must be refined. The tax exempt bond market incudes many securities that are merely pass-through obligations of businesses and private non-profit organizations. This is merely a device to allow States to grant subsidies to certain activities that they consider important through interest that is exempt from Federal income taxation. These "private activity bonds" must be excluded in the final rules.

Customer Transactions

The Proposed Rules implement the exception for customer transaction in Section 619 by identifying the three forms of transactions that fit within the exception:

- Transactions in which the customer is the beneficial owner and gains and losses go to the customer's account.

- Banking entities acting as "riskless principals," again in which gains and losses go to the customers' accounts.

- Certain insurance company activity on behalf of policyholders.[49]

These provisions are generally well structured and appropriate.

The customer transaction exception bears a possible relationship with the other exceptions. The inappropriate breadth of the market making exception and potentially the underwriting exception include activities that have emerged in recent years as profitable (and sometimes costly) business lines at banking entities. For example, banking entities have often taken on illiquid and complex derivatives risks at the request of customers. As discussed above, this activity simply cannot be permitted under the market making or underwriting exception.

However, Congress described how banking entities can serve the needs of customers to hedge these types of derivatives risks. The banking entities must assist with execution of these derivatives risk transactions under the customer transaction exception. The banking entity cannot make profit (or suffer loss) by taking principal risk on board. However, it can arrange a transaction between the customer and a non-banking entity.

Currently, the business of lending does not generate the levels of profits that the banking entities have grown accustomed to. They continue to want to leverage-up their business by taking on complex principal risk, hoping to call it market making or underwriting to avoid the prohibitions of Section 619. However, the inescapable purpose of Section 619 is to prohibit this behavior based on the recognition that the risk is inappropriate for banking entities that benefit from implicit federal subsidies that are transformed into realities as a consequence of a crisis situation.

Banking entities can provide services in complex and illiquid contracts, but only as an agent rather than as a principal.

Permitted trading outside of the United States

The clarity and consistency of the provisions addressing international scope of Section 619 are a positive element of the rule. The issue is a difficult one and the Agencies have crafted rules that work and provide certainty for the public as well as the banking entities.

However, it is important that these rules are not weakened. Question 141 is particularly worrying in this context:

Question 141. Should the Agencies use the authority provided in section 13(d)(1)(J) of the BHC Act to allow U.S.-controlled banking entities to engage in proprietary trading pursuant to section 4(c)(13) of the BHC Act outside of the United States under certain circumstances?

[49] Proposed Rules, Sections ___.6(b)(i)-(iii).

No, or at least only in extremely limited circumstances. Large global banks, like many sophisticated global corporations, generally manage their business operations on a globally consolidated basis. This means that total cash balances from all countries are moved in and out of the central corporate treasury on a daily basis. Thus, the total liquid resources of the global operation can be deployed by the parent company at all times. This has many advantages in minimizing tax, capital, and funding costs.[50] But for such integrated financial companies, losses in foreign subsidiaries can be disastrous to the parent company. Recall that the failure of Barings Bank after over 230 years of operation was due to actions by a single rogue derivatives trader in a Singapore subsidiary of the British bank. Recall also that AIG was exposed to massive derivatives losses through an affiliate located in London, AIG Financial Products. These were obviously extreme cases, but it is clear that large American banks organized on a global basis do routinely rely on cash flows from their foreign subsidiaries, and routinely fund losses at these subsidiaries. For reputational reasons it can be difficult for a parent company to simply refuse to honor debts incurred at a subsidiary, even if the parent has not explicitly guaranteed subsidiary debt (as often occurs). During the financial crisis, this reputational concern led to many banks taking off balance sheet vehicles experiencing funding difficulties back on their books even when they had explicitly stated they would *not* back such entities.

Section _7: Reporting and Recordkeeping Requirements

The reporting and recordkeeping requirements of the Proposed Rules are central to their ultimate effectiveness. The best outcome is compliance by banking entities, not enforcement by the Agencies, though credible enforcement is a necessary motivation and, when needed, a critical mechanism to remedy non-compliance.

The Agencies make clear that the Proposed Rules and the scope and utility of the information in Appendix A constitute the beginning of a process that is intended to grow into a functioning reporting regime.

> To be effective, this approach requires identification of useful quantitative measurements as well as judgment regarding the type of measurement results that suggest a further review of the trading unit's activity is warranted. The Agencies intend to take a heuristic approach to implementation in this area that recognizes that quantitative measurements can only be usefully identified and employed after a process of substantial public comment, practical experience, and revision.

A heuristic approach is logical. In continuing the process of developing and building out these metrics, the agencies should draw on resources and comment from the public as well as industry. The academic and public interest community should be included.

General Issues With Metrics Regime

[50] For a discussion, including the specific example of Lehman Brothers, see Herring, Richard and Jacopo Carmassi, "The Corporate Structure of International Financial conglomerates: Complexity and Its Implications for Safety and Soundness," in *The Oxford handbook of Banking*, ed. by Allen Berger, 2010

The use of quantitative metrics could create vulnerability to manipulation and arbitrage. For example, 7 out of the 17 major quantitative metrics rely on some measure of revenue volatility and/or internal risk metrics essentially based on modeling volatility.[51] Yet it is notoriously the case that instruments can be designed with significant tail risk that appear to have low volatility in normal market conditions, because the variance in losses only appears under stressed conditions.[52] The five "source of revenue" metrics (CFR 68958 – 68959) depend to one degree or other on correctly classifying revenue into market bid-ask spreads as opposed to other sources of revenue. Other metrics depend on correct tracking of inventory, which can be manipulated through moving assets either between desks or to securitization vehicles that are off the bank's balance sheet but may still represent a financial vulnerability of the bank.

We believe that these metrics cannot be expected to be fully reliable if banks are given unlimited scope and discretion in their market-making and underwriting activities. To take the clearest example, if banks are permitted to do market making and underwriting in completely customized and illiquid assets with no external market, then the price information for these assets will be generated purely by bank internal models. This will create enormous scope for manipulation of reported bid-ask spreads and asset price volatility. To take another example, an overly wide exemption for securitization will allow banks to structure complex relationships with third party securitization intermediaries that could allow movement of inventory off the bank's balance sheet, manipulation of fee and other customer based income transactions that are not arms length, and so forth.

The only way for regulators to prevent potential manipulations is to restrict bank activities to areas with observable outputs and clear relationships that bank examiners can be expected to track successfully. To put it another way, regulators cannot correctly measure bank activities without understanding the nature of those activities. This understanding will not occur unless activities are limited to relatively straightforward and genuinely market-based activities. Our recommendations elsewhere in this comment to restrict permitted activities to assets with clear markets, as well as to place strict limitations on the securitization exemption, should be understood in this spirit.

We have several other broad recommendations concerning metrics.

First, the metrics regime laid out here is well designed for market making, but is lacking in some areas when it comes to other permitted activities. This is especially glaring when it comes to hedging. We recommend adding additional metrics that are more directly applicable to other, non-market making activities:

- Hedging. The majority of the stated metrics are either poorly designed or completely inapplicable to hedging. A net profit metric should be added for hedging.

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[51] The seven metrics referred to are Value at Risk, Stress Value at Risk, VaR exceedance, and all four of the revenue to risk measurements. See CFR 68958-68960.

[52] Lo, Andrew, "Risk Management for Hedge Funds: Introduction and Overview", *Financial Analysts Journal*, November/December 2001, Vol. 57, No. 6: 16-33

- Underwriting. The amount of time to sell of market making positions should be tracked as an inventory metric.

These recommendations are discussed further in the detailed metrics section below.

Finally, we would recommend a special emphasis on inventory metrics, which make up only two of the listed 17 metrics. Most of the permitted activities have in common that they should induce low inventories to be held relative to customer demand. Inventories are costly for non-speculators. A prominent market microstructure expert has stated[53]:

> "If short and long positions are equally costly to create and hold, the target inventories of dealers who do not also speculate, hedge, or invest are zero. Dealers who hold no inventory avoid the costs of financing their positions, and they do not lose when prices move against their positions"

Furthermore, inventory levels are directly connected to systemic risk, as the larger the bank inventory the more exposed it is to market moves. We recommend that regulators make a special effort to track securities inventories at both the desk and overall bank level. This will not be simple, as there are many ways to manipulate inventory measurements by moving risks between desks or by recreating the same risk in a different instrument. This becomes even more true if banks are allowed unlimited ability to engage in securitizations, as assets can be moved from a trading desk book into CDOs and other structured products also owned by the bank. During the financial crisis, there were examples of bank personnel deliberately moving unacceptable risks between desks or on to bank-owned securitization to avoid risk oversight. [54]

In other inventory-related recommendations, we outline a new inventory risk measurement below, and at several points in this comment we recommend that bank compensation rules only permit bonuses to be given when assets (and their associated risks) have moved off the banking book.

Specific Metrics and Measurements

Hedging Metrics: The stated metrics are particularly poorly designed for hedging. Customer-facing metrics are irrelevant as the bank is its own customer, and it appears that hedging can potentially cover positions that the bank has accumulated as a principal outside of Section 619 prohibitions (for example, certain long term investments). Revenue to risk metrics are poorly designed to cover hedging as hedging activity will tend to show low profit volatility in any case. This will be true even if the hedge exemption is used to conceal an arbitrage or spread trade, as the proprietary trade will reap profits from a low-volatility spread between related instruments.

However, it is relatively simple to track abuse of the hedging exemption once we recall that the statutory purpose of hedging is limited to risk reduction and not profit generation. Hedging is not

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[53] Harris, Larry, Trading and Exchanges, Oxford University Press, 2003, p. 283

[54] Bernstein, Jake and Jesse Eisinger, "The Subsidy: How A Handfull of Merrill Lynch Traders Helped Blow Up Their Own Firm", Pro Publica, December 22, 2010; Bernstein, Jake and Jesse Eisinger, "Banks Self Dealing Super Charged The Financial Crisis", Pro Publica, August 26, 2010.

intended to be a bank profit center. Because of this, hedges should not consistently generate net profits for the bank. A metric should be designed to isolate net profits from hedging activity. If such profits are consistently positive this is evidence that the hedge exemption is being used for some form of spread trade.

Value At Risk: A threshold matter is the all-important methodology for assessing the risk of loss as a consequence of market price movements associated with positions held by banking entities. Appendix A of the Proposed Rules relies heavily on the concepts of Value at Risk ("VaR") and Stress Value at Risk ("Stress VaR"). These are defined as follows (CFR 68957):

> For purposes of this appendix, Value-at-Risk ("VaR") is the commonly used percentile measurement of the risk of future financial loss in the value of a given portfolio over a specified period of time, *based on current market conditions*. For purposes of this appendix, Stress Value-at-Risk ("Stress VaR") is the percentile measurement of the risk of future financial loss in the value of a given portfolio over a specified period of time, *based on market conditions during a period of significant financial stress*. [Emphasis added.]

The Agencies go on to describe a general methodological approach.

> Banking entities should compute and report VaR and Stress VaR by employing generally accepted standards and methods of calculation. VaR should reflect a loss in a trading unit that is expected to be exceeded less than one percent of the time over a one-day period.

VaR is based on statistical probability of result assuming historical price moves. The historic price moves represent the set of possible price moves over a defined period (generally a number of days) and there are a number of variants that take into account issues such as non-normal distribution of historic price data and weighting of categories of price data. In the quoted language, the Agencies have provided guidance that calls for price movements over a one-day period (suggesting that the measured portfolio would be liquidated in a day if necessary) and a confidence interval of 99% (suggesting that the consequences would be no worse than 99 out of 100 observed 1 day price moves). Further, Appendix A provides that VaR and Stress VaR calculations made pursuant to capital requirement regulation by a Federal banking agency.

This approach is clearly inadequate to measure risk in a real-world liquidation scenario. There is no guidance related to Stress VaR other than reference to "a period of significant financial stress." The events preceding the financial crisis suggest that risk measurement tools that appear to predict consequences of market dislocations can be worse than inadequate; they can provide a false sense of safety and cover for risk taking. The Agencies must change the approach to these risk measurements as follows:

- A one-day holding period assumption is inadequate, especially for less liquid asset classes.

- The VaR analytics must align with the historic behavior of the securities or derivatives in the portfolio. For instance, if price change data is distributed non-normally, a Monte Carlo methodology must be used.

- Stress VaR must measure potential results without being bounded by historic precedents and should be linked to the broader stress testing regime. It must be based on "extreme but plausible" conditions, explicitly de-linking the analysis from historic precedent. Stress VaR using extraordinarily high confidence intervals is a useful measure. However, a true stress test based on extreme but plausible conditions is necessary.

Portfolio Profit And Loss: Overall, profit and loss, and more specifically the volatility of profit and loss, can signal proprietary trading and must monitored. Portfolio Profit and Loss to Volatility Ratio is a ratio of Portfolio Profit and Loss, exclusive of Spread Profit and Loss, to the Volatility of Portfolio Profit and Loss, exclusive of Spread Profit and Loss, for a trading unit over a given calculation period and must be monitored. Former Chairman Volcker identified this parameter as central to the identification of speculation.[55]

> An analysis of volume relative to customer relationships and of the relative volatility of gains and losses would go a long way toward informing such judgments. For instance, patterns of exceptionally large gains and losses over a period of time in the "trading book" should raise an examiner's eyebrows. Persisting over time, the result should be not just raised eyebrows but substantially raised capital requirements.

As a consequence, the Agencies should establish a clear pattern of profit and loss results of individual trading units through iterative application of metrics.

Identification of Market Making: Customer-Facing Component: Appendix B to the proposed rules consists of a useful and insightful Commentary Regarding Identification of Permitted Market Making-Related Activities. Market making businesses can be seen as having two components. First, is the customer-based activity in which positions facing customers are taken and then offset in the market. The second component is the inventory that is held to accommodate the customer-based activity. Each must be evaluated separately in the process of determining if the business is *bona fide* market making. Variations between the actual results measured by revenue and the revenue results that would be anticipated were the business *bona fide* market making would constitute markers suggesting that further inquiry is needed.

In the customer-based component, the test must compare the actual revenue results of trades with a measurement of the expected revenue results. Generally, the expected revenue result is measured by the spread between the customer execution price and the covering price available in the market, often referred to as the bid/ask spread. (Note that the assumption is that, for each market making customer trade, the banking entity will be able to forecast the financial results of

[55] Statement of Paul A. Volcker Before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, Washington, DC, February 2, 2010.

covering that trade. Implicitly, a market must exist for the security or derivative that is transparently priced and liquid enough so that the forecast can be made. As described above, this is an essential, defining characteristic of market making.) Forecasted revenue consequences must be applied to each trade and reported.

Actual revenue results are the difference between the customer execution price and the actual cover price. The covering transaction might be executed in the market. Cover can also be ascribed to inventory, in which case the covering transaction should be priced at the inventory replacement price on a first in time basis (i.e., inventory replacement should be allocated to customer-based transactions in order of occurrence). In each case, in a *bona fide* market making business, covering transactions should be executed promptly so that actual revenue results are close to forecasted revenue results.

If a covering transaction is a hedge of the underlying customer-based position, the actual results should be measured as the difference between the customer-based transaction price and the price at which the hedge is put on.

It should be noted that many of these factors are addressed in the discussion of Spread Profit and Loss in Appendix A. However, this discussion takes a seriously flawed turn when it attempts to analyze illiquid positions (CFR 68958-68959):

> For other asset classes in which a trading unit is engaged in market making-related activities, bid-ask or similar spreads may not be widely disseminated on a consistent basis or otherwise reasonably ascertainable. A covered banking entity must identify any trading unit engaged in market making-related activities in an asset class for which the covered banking entity believes bid-ask or similar spreads are not widely disseminated on a consistent basis or are not otherwise reasonably ascertainable and must be able to demonstrate that bid-ask or similar spreads for the asset class are not reasonably ascertainable. In such cases, the trading unit should calculate the Spread Profit and Loss for the relevant purchase or sale of a position in a particular asset class by using whichever of the following three alternatives the banking entity believes more accurately reflects prevailing bid-ask or similar spreads for transactions in that asset class:
>
> (i) End of Day Spread Proxy: A proxy based on the bid-ask or similar spread that is used to estimate, or is otherwise implied by, the market price at which the trading entity marks (or in the case of a sale, would have marked) the position for accounting purposes at the close of business on the day it executes the purchase or sale ("End of Day Spread Proxy");
>
> (ii) Historical Data Spread Proxy: A proxy based on historical bid-ask or similar spread data in similar market conditions ("Historical Data Spread Proxy"); or

(iii) Any other proxy that the banking entity can demonstrate accurately reflects prevailing bid-ask or similar spreads for transactions in the specific asset class.

A covered banking entity selecting any of these alternatives should be able to demonstrate that the alternative it has chosen most accurately reflects prevailing bid-ask or similar spreads for the relevant asset class.

This tortured analysis makes obvious that the application of "spread proxies" means that there is no spread and no way to effectively calculate Spread Profit and Loss. If the only way to estimate a price is for the trader to hang a price tag off of it or for the trading firm to analogize to another type of instrument for which a market actually exists, there is no way to conclude that the banking entity had any reasonable basis to anticipate the financial consequences of the customer-facing transaction when it was entered into. Whatever the banking entity was doing when it entered into the transaction, this demonstrates that *it was not market making.* To conclude otherwise flies in the face of the obvious intent of Congress that market making is fundamentally a client service involving two-sided position taking, as discussed above.

We invite the Agencies to inquire as to all of the types of positions that various traders have sought to value as if there were a market for them, and suggest that the historical inquiry commence with Enron. One must conclude that taking on positions that the banking entity can only value by the asking the trader (or trading desk) that does the deal to estimate a price is precisely the kind of activity that Section 619 was intended to prohibit. The issues created by permitting market-making in instruments with no external market are even more clearly evident in the attempt to measure the activity quantitatively.

Identification of Market Making: Inventory Component. In a *bona fide* market making business, inventory positions should be viewed as a cost of doing business. Inventory ties up capital and exposes the banking entity to risks. The all-in cost of carrying the entity should be small compared with the revenue of the customer-based component of the market making business. We recommend the Agencies consider two additional measures associated with inventory carrying costs.

- Risk of loss and potential for gain should be measured. If either is larger than appropriate relative to the revenue of the purported market making business, this would constitute a marker that the activity is not *bona fide* market making. Given the relative predictability of revenue in a *bona fide* market making business, a low level is appropriate, perhaps 2% (assuming a quarterly measurement).

  The un-hedged VaR of the inventory positions (including the VaR of the basis between the hedge and the underlying position) is a key element. In addition the realized loss and the realized gain on inventory positions (including the realized loss and the realized gain associate with basis differential between inventory positions and hedges) should be separately measured.

  - Risk of loss is the aggregate of the VaR and the realized losses since the last

measurement.

  - Potential for gain is the aggregate of the VaR and the realized gain since the last measurement.

- Asset volatility is also a separate and important measure. Volatility must be no more than the volatility of the asset class. In fact, it should be far lower since the inventory should be prudently hedged.

- Ongoing profit and loss that is not proportionate must also be a marker. Each must be measured separately since the marker should reflect potentially disguised proprietary trading, rather than net results. Again, the percentage should be low, perhaps one percent of customer-based revenue over a quarterly period.

Underwriting Metrics. Quantitative measurement of markers for non-*bona fide* underwriting is virtually ignored in the Proposed Rules. This is not appropriate. Like market making, underwriting should be defined in part by the ability of the banking entity to forecast the financial results of the activity. In a *bona fide* underwriting, the syndicate should expect to earn the underwriting discount agreed to in the purchase contract with the issuer, based on sales allocations and adjusted for specific factors. Managers earn fees in addition. Losses or gains on the positions associated with unsold balance are additional revenue consequences.

A significant relevant issue in underwriting is the allocation of unsold balances on the basis of the share of syndicate risk established in an agreement among underwriters. In a *bona fide* underwriting, unsold balances should be relatively small and should be covered promptly. (Unsold balances should include all securities remaining in inventory after the syndicate books are closed.) A marker for potential non-*bona fide* underwriting should be recognized if the VaR (un-hedged and uncovered) of the allocated unsold balance that is allocated to a banking entity is large relative to the expected revenue measured by pro rata underwriting spread. This measure should also include the VaR of basis risk in hedges. The threshold percentage should be very low, perhaps 2%.

In addition, both large and non-existent unsold balances overall must be considered to be markers. While not all underwritings proceed as anticipated, *bona fide* underwritings should generally clear the market. Otherwise the underwriting activity is either not successful (or super-successful) for unexpected reasons or is entered into based on motivations different from client service. The proto-typical client-oriented underwriting results in a modest unsold balance. Variation from this merits inquiry. The appropriate level of anticipated unsold balance requires investigation best pursued by the Agencies.

_8: Limitations on Permitted Proprietary Trading Activities

This section and Section _17 implement the crucial 13(d)(2) limitations on permitted activities. The safety and soundness and systemic risk limitations (13(d)(2)(A)(ii) through (iv)) are simply listed in the rule without further comment. Presumably this is because they are implemented through the specific definitions of each permitted activity. The comments below apply to both this section and Section _17.

Conflicts of Interest

The major discussion is devoted to the implementation of conflict of interest restrictions. Section 619 creates a general prohibition on permitted activities that would involve or result in a conflict of interest:

> No transaction, class of transactions, or activity may be deemed a permitted activity under paragraph (1) if the transaction, class of transactions, or activity… would involve or result in a material conflict of interest (as such term shall be defined by rule as provided in subsection (b)(2)) between the banking entity and its clients, customers, or counterparties….

The reference to "counterparties" here is particularly telling, as it indicates that Congress wished to restrict conflicts of interests even with respect to sophisticated, arms-length market participants to whom fiduciary duties would typically not apply.[56] This gives a sense of the sweeping and forceful nature of the Section 619 conflict of interest ban.

The Proposed Rules implement this provision by creating a definition of "material conflict of interest" that would prevent any such conflicts from falling under the Section 619 ban so long as the conflict was disclosed or was neutralized through an information barrier or 'firewall'. Section __.8(b)(1)(ii) of the proposed regulations prevent a material conflict of interest from existing if the banking entity makes "clear, timely, and effective disclosure" of the conflict. Section _8(b)(2) similarly prevent a material conflict of interest from existing so long as the banking entity has established information barriers, outlined in written policies and procedures, that would "prevent the conflict of interest from involving or resulting in a materially adverse effect on a client or counterparty".

This falls well short of the statutory intent. The Proposed Rules substantially narrow the scope of Section 619 by excluding conflicts that have been disclosed as described therein and excluding conflicts of banking entities where information barriers have been put in place. There is nothing in the text of Section 619 that suggests that Congress intended such a narrowing. An enlightening contrast is the commentary on the proposed regulations for Section 27B (Section 621 of Dodd-Frank, a companion provision also dealing with conflicts of interest in securities transactions). This discussion states that the SEC did not intend to suggest that "a transaction otherwise prohibited under the proposed rule would be permitted if there were adequate disclosure by the securitization participant," and acknowledge potential "practical challenges in relying on disclosure as a means to address all transactions involving a material conflict of interest."[57] The misgivings about disclosure as a means of escaping liability that were expressed in the SEC proposal to implement Section 27B are entirely well-founded, and should apply equally to the proposed Volcker Rule regulations.

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[56] Andrew F. Tuch, Working Paper, *Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs*, April 2011, *available at* http://ssrn.com/abstract=1809271

[57] Prohibition against Conflicts of Interest in Certain Securitizations, S.E.C. Release No. 34- 65355, at 45-46 (proposed Sept. 19, 2001) (to be codified at 17 C.F.R. pt. 230).

The effectiveness of disclosure is fundamentally a matter of great concern. Such requirements have a powerful tendency to devolve into *pro forma* standardized information. Furthermore, disclosure can have perverse effects on both the disclosing party and the party that is disclosed to. Empirical research on the behavioral effects of conflict of interest disclosure has demonstrated that, in contexts such as financial transactions, disclosure of conflicts provides moral license to the disclosing party to provide biased advice.[58] That is, it can backfire by alleviating the guilt of the conflicted party. Disclosure can also perversely cause the party receiving the disclosure to actually become more credulous of the disclosing party, since it is then perceived as more trustworthy.[59]

There are also severe problems with the exclusive use of information barriers. Information barriers invite abuse on the part of the company that implements them, and thereby present major enforcement problems. There have been several recent high-profile scandals involving the breach of internal information barriers, including an SEC enforcement action against Merrill Lynch and the stock research analyst scandals of the early 2000s.[60] There is also empirical evidence that investment banks make unusually high returns in trading the stock of companies involved in merger and acquisition deals that they have advised, suggesting that they systematically make use of non-public information despite information barriers.[61] Finally, the practicality of information barriers is questionable when applied to broad views of a banking entity relating to markets and economic directions, as these will and should be widely known within the banking entity.

This casual approach to the enforcement of a major provision of Section 619 needs to be rethought by regulators. Future separate rulemakings in specific areas may be necessary to effectively enforce the Section 619 prohibition on the existence of conflicts of interest. In the meantime, the proposed rules should be strengthened in the following ways:

- The final rules should strengthen the disclosure requirement by specifying that the banking entity must disclose details of the positions and the strategies that could reasonably involve or result in a materially adverse effect on the customer, client or counterparty. Otherwise disclosure will become a mere pro forma notification.

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[58] Daylian M. Cain, George Lowenstein, & Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005); Daylian M. Cain, George Lowenstein, & Don A. Moore, *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest*, 37 J. CONSUMER RES. 836 (2011) (presenting the results of four studies that suggest disclosure backfires).
[59] *See id.* at 5-6; Fiona Lee, Christopher Peterson, and Larissa Z. Tiedens, *Mea Culpa: Predicting Stock Prices from Organizational Attributions*, 30 PERSONALITY & SOCIAL PSYCHOLOGY BULLETIN 1636 (2004).
[60] See SEC Order Against Merrill Lynch, Pierce, Fenner & Smith Incorporated, 25 March 2011 (available at http://sec.gov/litigation/admin/2011/34-63760.pdf); DAVID CALLAHAN, THE CHEATING CULTURE: WHY MORE AMERICANS ARE DOING WRONG TO GET AHEAD 152 (2004) ("A second [failure] was the fall of the 'Chinese Wall' that was supposed to separate stock research analysts from investment bankers, providing the incentive for star analysts like Henry Blodget and Jack Grubman to mislead investors on a massive scale.").
[61] *See* Andriy Bodnaruk, Massimo Massa & Andrei Simonov, *Investment Banks as Insiders and the Market for Corporate Control*, 22 REV. FIN. STUD. 4989 (2009).

- The regulations should require the conflicted entity to obtain affirmative consent from the other party to the specific conflicted transaction. As above, the conflicted entity should be required the exact nature of the conflict and the economic value of the conflict to the covered banking entity, not merely provide them with notice.

- The rule should specify the type and nature of information barriers and the required cases where they are practical to implement, such as barriers between order flow traders in market-making and advisors or managers of bank-sponsored hedge funds.

_Section 8(c): High Risk Assets And Trading Strategies

Question 213. Is the proposed rule's definition of a high-risk asset effective and sufficiently clear?

Question 214. Is the proposed rule's definition of a high-risk trading strategy effective and sufficiently clear?

The definition put into the proposed rule here and in Section _17 is inadequate. It is in fact a circular definition (essentially, a high risk asset is an asset that creates high risk). It is perhaps intended as a placeholder pending the completion of the study mandated in Section 620.

Nevertheless, the high risk asset and trading strategy restriction is a very important one, as it permits regulators to directly shield the banking system from dangerous 'financial innovations' that pose systemic risk without corresponding real economy economic benefits. This restriction is particularly important as regulators have chosen to allow a broad exemption for investment in and sponsorship of securitization vehicles and also have not placed sufficient (or indeed any clear) restrictions on the type of assets eligible for market making or underwriting activities. The preferable approach is to limit these exemptions and create reasonable restrictions within the permitted activities themselves. (For example, the restrictions we suggest above on instruments eligible for permitted activities would effectively ban market making and underwriting in instruments that cannot be externally priced). However, should this not be done in the final rule, the high risk asset and trading strategy backstop may have to carry much of the weight in protecting the integrity of the rule. If so, it is imperative that they be more effectively and specifically defined.

There is a move toward a more effective definition of high risk assets in Appendix C. On CFR 68964 such instruments / trading strategies are specified as:

- Assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated;

- Assets whose changes in values cannot be adequately mitigated by effective hedging;

- New products with rapid growth, including those that do not have a market history;

- Assets or strategies that include significant embedded leverage;

- Assets or strategies that have demonstrated significant historical volatility;

- Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and

- Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;

This is a very good conceptual start and hopefully will inform the report written for Section 620. Unfortunately the regime outlined in Appendix C is unlikely to lead to a significant progress in restricting these instruments, as it simply requires a written description of ways the bank prevents exposure to such instruments, and is not backed up by other elements of the rule.

_10: Prohibitions on Acquiring or Retaining And Ownership Interest In And Having Certain Relationships With Covered Funds

The Dodd-Frank Act contains clear requirements for strict limitations on bank investments in hedge and private equity funds. Such investments are limited to 3 percent of bank tier 1 capital, and a bank may no own more than 3 percent of a covered fund.

Section _10(b)(1): Definition of "Covered Fund"

The definition of "covered fund" is central to whether the Volcker Rule will fulfill its promise of limiting the extent to which banking entities can engage in excessively risky activities that could result in tax-payer funded bank bailouts. A broad definition of covered fund can help limit banking entities' risk exposures.

The proposed rule follows the scope of the statutory definition by covering an issuer only if it would be an investment company, as defined by the Investment Company Act, *but for* section 3(c)(1) or section 3(c)(7) of that Act…The Agencies have proposed to include as "similar funds" a commodity pool, as well as a foreign equivalent of any entity identified as a "covered fund."

We believe this is the correct approach. Covered fund managers traditionally have a lot of latitude in selecting their investment strategies and by focusing on the standard characteristic which defines these unregulated pooled investment vehicles – the exemptions under sections 3(c)(1) and 3(c)(7) of the Investment Company Act – the Agencies ensure that banking entities will not have excessive exposure to risky investment strategies and that covered funds do not become a vehicle for evasion of the Volcker Rule.

Question 221. Should the definition of "covered fund" focus on the characteristics of an entity rather than whether it would be an investment company but for section 3(c)(1) or section 3(c)(7) of the Investment Company Act?

It would not be appropriate to focus on the characteristics of an entity rather than its use of the above-mentioned exemptions from the Investment Company Act. The common, static defining characteristic of a private fund is its use of the exemptions provided by section 3(c)(1) and

section 3(c)(7) of the Investment Company Act. Using other characteristics to define a covered fund, such as leverage or fee structures, would create arbitrage opportunities and would be difficult to implement.

Question 222. Instead of adopting a unified definition of "covered fund" for those entities included under section 13(h)(2)of the BHC Act, should the Agencies consider having separate definitions of "hedge fund" and "private equity fund"?

Private funds are known for having transient investment strategies. This is acknowledged by the United Kingdom's Financial Services Authority in a 2005 report on hedge funds and potential systemic risks, in which it states that a primary characteristic of hedge funds is that they have "broader mandates than traditional funds which give managers more flexibility to shift strategy."[62]

The Managed Funds Association defined "hedge fund" as a pooled investment vehicle that "generally meets the following criteria: (i) it is not marketed to the general public (i.e., it is privately-offered), (ii) it is limited to high net worth individuals and institutions, (iii) it is not registered as an investment company under relevant laws (e.g., U.S. Investment Company Act of 1940, as amended), (iv) its assets are managed by a professional investment management firm that shares in the gains of the investment vehicle based on investment performance of the vehicle, and (v) it has periodic but restricted or limited investor redemption rights."[63] This definition would include hedge funds, commodity pools, and other types of investment vehicles.

Due to the history within the private fund market in which private fund advisers are frequently allowed substantial leeway to pursue a wide range of investment strategies, we are concerned that imposing regulatory distinctions among types of funds when these distinctions may not exist in practice could provide opportunities for regulatory arbitrage. In order to avoid this, the Agencies should not attempt to write a rule that focuses on the characteristics of the entity, which are likely to change over time.

Section _10(b)(3)(ii)(A): Carried interest (Question 234)

This section exempts grants of 'carried interest' from the definition of an "ownership interest" in a covered fund. Such interest may be granted to the bank itself, any affiliate, or any bank employee. The carried interest grant must be made for the sole purpose of performance compensation, must not be acquired in exchange for bank funding, may not be reinvested in the fund, and must be subject to clawback provisions (presumably based on fund performance).

This carried interest exemption is too broad. It creates a potentially significant linkage between bank revenue flows and proprietary exposures. NYU Stern School finance professor Matthew Richardson has explained how fees from asset management create proprietary exposures[64]:

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[62] Financial Services Authority, *Hedge funds: A discussion of risk and regulatory engagement* (Jun. 2005), available at http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf.

[63] Managed Funds Association (MFA), *Sound Practices for Hedge Fund Managers*, Washington, 2007.

[64] Richardson, Matthew, "Large Banks And the Volcker Rule", in Regulating Wall Street: The Dodd Frank Act and The New Architecture of Global Finance, New York University Stern School, 2011, p. 193.

> "At first glance, it may seem that activities based solely on fee revenue, such as asset management, advisory roles, or brokerage services, are not systemic in nature. This is incorrect. If the stream of revenue from these businesses is capitalized by the equity market and the firm can borrow against this capitalization, then a loss in the present value of revenues can have an effect similar to investing ones' own capital. Consider the asset management business. Since, through its fee structure, asset management revenues are a function of the value of the underlying assets being managed, any market risk of these assets will get passed through to the value of the asset management business."

This is exactly the kind of fee exposure created through carried interest. The statutory limits on hedge and private equity fund investments are very clearly intended to severely limit if not eliminate bank proprietary exposures through such funds. Yet excessive exposures through market-linked fee revenues can have many of the same effects.

In addition, carried interest is paid to a covered fund manager based on fund performance and is often paid on unrealized returns. As a result, carried interest typically may be clawed back if those returns are not realized (such clawback provisions are apparently required here). Even after carried interest is paid, the banking entity is still exposed to the risk that it will have to return that money. The ongoing risk exposure associated with carried interest is another reason it is not appropriate to exclude carried interest from the definition of "ownership interest."

The statute does allow asset management services and such services do need to be compensated in ways that provide incentives for effective management. Yet regulators should seek out compensation structures that do not create too tight a link between large bank funding streams and asset market volatility.

An open-ended exemption from statutory limits for carried interest is not the way to do this. Regulators should strike this exemption in favor of a greater reliance on management fees. Management fees also serve to align incentives with the fund investors, but have a lower market volatility than a pure share of profits. In fact, there is research showing that the asymmetry of the carried interest structure – which rewards gains more than it penalizes losses – is problematic for investors compared to management fees.[65] Failing that, they should at least limit total carried interest. Regulators should also consider permitting carried interest to be held only by bank employees, as opposed to the bank or bank affiliate.

As a final note, since carried interest here is designated purely as performance compensation, it should clearly receive tax treatment as ordinary income.

Securitization – Overview To Questions 229, 231, 232, 235 - 240

The interaction between securitization and the Volcker Rule creates many complex challenges for regulators. In thinking about these challenges, it is useful to review some basic points about securitization. From a position of relative unimportance before the early 1990s, private credit securitization grew rapidly to become a central channel for consumer credit by the middle of the

[65] Kritzman, Portfolio Efficiency with Performance Fees, Windham Capital Management, 2007; Hurlburt, Mark, "2+20 And Other Hedge Fund Math", New York Times, March 4, 2007.

last decade.[66] By 2006, there was $1.6 trillion in private securitized debt issued.[67] The American Securitization Forum estimates that securitization has funded between 30 and 75 percent of outstanding consumer credit in various markets, including two thirds of mortgage lending.[68] The central role of private securitization in pre-crisis consumer credit markets clearly helps to explain why many regulators and policymakers consider it imperative to revive some form of private securitization.[69]

But during the crisis securitization was also revealed to be the core driver of systemic risk in the financial system, and to be the central force behind funding a system of unregulated shadow banks that posed grave systemic threats.[70] Originate to distribute securitization markets rested on shaky legal grounding and apparently fueled a race to the bottom in lending standards.[71] The complexity of securitization structures concealed a massive failure in credit assessment for senior tranches of structured instruments.[72] It was these senior tranches which supported liquidity in the repo market. This created a failure in bank liquidity, and resulted in collateral fire sales that led to risk contagion between asset markets and the failure of undercapitalized banks.[73] This undercapitalization was also intimately connected to securitization, as banks used securitization vehicles to remove low-quality debt from their balance sheets, avoid capital charges, and transfer risks to the unregulated shadow banking system.

As a result, liquidity and credit provision in private securitization markets vanished almost overnight and still has not revived. Total private issuance of asset backed and mortgage backed securities has declined by over 90 percent, from $1.6 trillion in 2006 to about $125 billion in 2010, despite some Federal Reserve backing through the Term Asset Lending Facility.[74] Indeed, the private MBS market has disappeared almost completely. Surprisingly, the non-mortgage ABS market also collapsed and needed significant Federal Reserve support, indicating the issue was not simply the poor quality of subprime mortgage collateral but a broader issue with securitization structures and financial fragility.[75] This is not the first time that securitization markets have exploded in size and then vanished almost overnight due to a systemic crash. Economists have documented similar boom-bust patterns in the late 19th century and in the 1920s

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[66] Statement of Tom Deutsch Before the House Financial Services Committee, April 14, 2011. Appendix A documents that between 1990 and 2006 mortgage securitization grew almost tenfold and asset backed securitization almost twenty-fold.
[67] SIFMA, "US ABS Issuance and Outstanding".
[68] Statement of Tom Deutsch Before the House Financial Services Committee, April 14, 2011. This includes GSE backed securitization.
[69] Walsh, John, "Remarks Before the American Bankers Association Government Relations Summit." *Office of the Comptroller of the Currency* (March 2011).
[70] Martin, John D., A Primer on the Role of Securitization in the Credit Market Crisis of 2007 (January 7, 2009); Stein, Jeremy, "Securitization, Shadow Banking, and Financial Fragility", Harvard University, May, 2010.
[71] McCoy, Patricia A., Pavlov, Andrey D. and Wachter, Susan M., Systemic Risk through Securitization: The Result of Deregulation and Regulatory Failure (February 9, 2009). Connecticut Law Review, Vol. 41, p. 493, May 2009.
[72] Moody's Investors Service, "Default and Loss Rates of Structured Finance Securities, 1993-2010", Special Comment, September 30th, 2011.

[73] Gorton, Gary B. and Metrick, Andrew, Securitized Banking and the Run on Repo (November 9, 2010). Yale ICF Working Paper No. 09-14.
[74] SIFMA, "US ABS Issuance and Outstanding"
[75] Stein, Jeremy, "Securitization, Shadow Banking, and Financial Fragility", Harvard University, May, 2010.

prior to the Depression.[76]

Both the strengths and weaknesses of securitization are intimately linked to the way that securitization works through third party intermediaries. The key properties that make securitization an attractive financial proposition, such as risk transfer, bankruptcy remoteness, and (for regulated entities) the ability to reduce capital charges, are all driven by the transfer of securitized assets to an intermediary vehicle.[77] The relationship between the securitization sponsor and the intermediary is very significant, since both academic research and recent experience suggests that securitization would not be an attractive investment without an understanding that the intermediary had implicit recourse to the sponsor in case of financial difficulties.[78] At the same time, the third party intermediary aspect of securitization is also central to the ways securitization is a driver of systemic risk. As described in the literature cited above, risk transfer can become a way to conceal risks and a disincentive to properly assess them. The reduction of capital charges can become regulatory arbitrage. Securitization intermediaries are the central conduits for financing the shadow banking system.

These considerations make it clear that the issues raised by the relationships with third party funds and the securitization markets are exceptionally important. Several general conclusions arise. First, regulators should not let the economic significance of securitization in the pre-crisis bubble period lead them to place broad or sweeping securitization-related exemptions in the rule. The enhanced liquidity and credit availability created by pre-crisis securitization turned out to be in many ways a mirage. The experience of the United States from the 1940s to the 1980s demonstrates clearly that healthy credit markets can exist without large-scale private securitization. Furthermore, Section 619 does not explicitly restrict securitization sponsorship by non-bank entities, meaning that securitization markets will still have access to capital.

Second, the crisis has now demonstrated beyond doubt that securitization poses inherent systemic risks. This means that any broad or indiscriminate securitization exemption will violate the Section 13(d)(2) requirements that permitted activities do not pose systemic risk. If securitization activities are permitted under the Section 13(d)(1)(J) authority to introduce new permitted activities, then such activities must be tightly and thoughtfully restricted to avoid recreating the systemic risks inherent in the unlimited ability to securitize debt. Given the history and the evidence it is simply no longer plausible to claim that an indiscriminate securitization exemption would enhance the financial stability of the United States, as Section 13(d)(1)(J) requires.

In the discussion for Section _13 below, we develop these conclusions further and recommend that that any exemption for securitization must be narrowly tailored and should follow a 'safe

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[76] Kenneth A. Snowden, Mortgage Companies and Mortgage Securitization in the Late Nineteenth Century 31-32 (unpublished manuscript); Kenneth A. Snowden, The Anatomy of a Residential Mortgage Crisis: A Look Back to the 1930s 11-12 (Nat'l Bureau of Econ. Research, Working Paper No. 16244, July 2010); William N. Goetzmann & Frank Newman, Securitization in the 1920's (Nat'l Bureau of Econ. Research Working Paper No. 15650, January 2010).

[77] Gorton, Gary B. and Metrick, Andrew, Securitization (November 17, 2011).

[78] Higgins, E., Mason, J. (2004). "What is the Value of Recourse to Asset-Backed Securities? A Clinical Study of Credit Card Banks". Journal of Banking and Finance, 28, 875-89. Gorton, Gary and Nicholas Souleles, "Special Purpose Vehicles and Securitization", in The Risks of Financial Institutions, National Bureau of Economic Research, January, 2007.

harbor' approach in carefully defining the exact securitization structure that qualifies for the exemption. In this section, regulators pose a number of securitization-related questions regarding their stated preliminary belief that securitization vehicles from various covered fund definitions. Drawing on the overview discussion here, we briefly answer some of those questions below.

Question 229. Are there entities that issue asset-backed securities (as defined in Section 3(a) of the Exchange Act) that should be exempted from the requirements of the proposed rule? How would such an exemption promote and protect the safety and soundness of the banking entity and the financial stability of the United States as required by section 13(d)(1)(J) of the BHC Act?

As outlined in the Overview section on securitization immediately above these responses, there is no longer any doubt that securitization poses inherent systemic risks that must be controlled. Given recent experience, a loose and ad hoc securitization exemption could not possibly enhance financial stability as required by Section 13(d)(1)(J). If regulators do choose to exempt any securitization activities under the Section 13(d)(1)(J) authority, then such activities must be tightly and thoughtfully restricted to avoid recreating the systemic risks inherent in the unlimited ability to securitize debt. Such a tightly restricted securitization exemption could only be workable if it were structured as a 'safe harbor' exemption that applied only to a particular pre-specified securitization form that was transparent and standardized. Any such exemption needs to tightly and carefully pre-specify the exact securitization form that is permitted, and justify the reasons why it is protected against the systemic risks that were associated with securitization. This simple, standardized approach would allow for better market discipline and better regulatory oversight than were seen in securitization markets prior to the crisis. An ad hoc exemption for broad types of ABS issuers could certainly be gamed in ways that would undermine statutory intent.

Question 231. Many issuers of asset backed securities have features and structures that resemble some of the features of hedge funds and private equity funds (e.g., CDOs are managed by an investment adviser that has the discretion to choose investments, including investments in securities). If the proposed definition of ''covered fund'' were to exempt any entity issuing asset-backed securities, would this allow for interests in hedge funds or private equity funds to be structured as asset-backed securities and circumvent the proposed rule? If this approach is taken, how should the proposal address this concern?

Question 232. Are the structural similarities between an entity that issues asset-backed securities and hedge funds and private equity funds of sufficient concern that the Agencies should not exclude any entity that issues asset-backed securities from the definition of covered fund?

As the regulators correctly point out, so-called 'market value', 'managed', or 'arbitrage' CDOs allow a collateral manager to effectively do proprietary trading with the ABS collateral pool.[79] The manager has the ability to trade instruments out of the collateral pool and buy new additions to the pool based on market values. The entire collateral value is marked to market. This is effectively an interest in a hedge or private equity fund structured as an asset backed security. Exempting investment in such an ABS from Volcker Rule restrictions would open up a large and

[79] Jobst, Andreas A., Collateralised Loan Obligations (CLOs) - A Primer (December 2002). CFS Working Paper No. 2002/13.

obvious loophole and would undermine the statutory intent to tightly restrict hedge and private equity investments.

The structural similarities between ABS intermediary entities and restricted hedge and private equity funds are indeed of grave concern. Should a securitization-related exemption be granted, any looseness in the definition of an exempted ABS issuer could be exploited to create exposures (potentially significant ones) to prohibited proprietary trading. This is an important reason why any such exemption needs to be structured as a 'safe harbor' for a standardized and pre-specified form of securitization. To protect against the problems outlined in these questions, such a safe harbor securitization must be a cash flow securitization, not based on mark-to-market values, and there must be no ability to modify the collateral pool from the point the securitization reaches the market. (Note that these do not exhaust the restrictions that should be put on such a safe harbor securitization form to prevent systemic risk, although they do address the problems raised in the questions above).

Questions 235 to 240; Questions 274 to 275: 'Ownership interest' as applied to securitizations – is only the residual tranche an ownership interest?

Without reproducing these questions, we give a general note on the issue of debt vs. equity interests in securitizations. This issue is relevant both to the definition of ownership in this section and the calculation of aggregate ownership interests in Section _13. Because pooling and servicing agreements for securitizations are not standardized, these governing agreements can potentially divide control rights in very different ways than a simple division between residual cash flows and debt would imply. The scope for customizing such trust agreements means that any general statement that senior or mezzanine tranches do not constitute 'ownership' of a securitization is likely to be both problematic and easy to evade. Regulators should avoid such a general exemption. This once again points to the utility of creating a standardized, pre-specified securitization form that would serve as a safe harbor in any exemption of securitization vehicles or assets from a Volcker Rule restriction.

Section _11: Permitted Organizing And Offering Of A Covered Fund

Section _11(b): 'Customers of Such Services' Requirement

The rule does not effectively enforce this critical statutory language through a requirement that the customer be an actual, pre-existing customer of the bank. Instead, the Agencies state on CFR 68901:

> "Section 13(d)(1)(G)(ii) of the BHC Act does not explicitly require that the customer relationship be pre-existing. Accordingly, the proposed rule provides that it may be established through or in connection with the banking entity's organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of bona fide trust, fiduciary, investment advisory or commodity trading advisory services to the customer. This application of the customer requirements is consistent with the manner in

> which trust, fiduciary, investment advisory, and commodity trading advisory services are provided by banking entities. Historically, banking entities have raised capital commitments for covered funds from existing customers as well as individuals or entities that have no pre-existing relationship with the banking entity."

The historic practices of banking entities are not relevant to the interpretation of a statutory provision clearly intended to materially restrict such practices. To allow the customer relationship to be spawned by the actual offering of fund interests simply eliminates the substantive requirement of Section 619 that "the fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, or investment advisory services and only to persons that are customers of such services of the banking entity…" It makes no sense that an offering to an entity that will become a customer if the offer is accepted is deemed to be an offering to a customer.

The final rules should require that the offeree have a pre-existing customer relationship with the banking entity.

Section _12: Permitted Investment in A Covered Fund

Section _12(a)(2): Ownership Limits

The Proposed Rules permit unlimited investment in covered funds for the purpose of establishing a covered fund so that it can attract unaffiliated investors. The covered banking entity must actively seek unaffiliated investors and reduce its ownership interest to acceptable *de minimis* levels within one year. This is a potentially significant exception to the general rule that requires that banks engage in subsequent corrective action to bring investment levels down to specified limits. As such, it may well become a vehicle for abuse and evasion.

The final rule must tighten the process for first year offerings of and investments in funds. For each seeded fund, the CEO of the banking entity should be required to certify that the plan to attract unaffiliated investors has reasonable prospects for success. Furthermore, the final rules should provide that if the *de minimis* levels are not achieved, the fund will be subject to liquidation.

Section _12(a)(2)(i)(B): *Ownership Limits*

The statute specifies both that covered fund investments must be 'immaterial' to the bank (Section 13(I)(4)(B)(ii)(II)) and also that they may not exceed 3 percent of the bank's Tier 1 capital. There is no mention of the 'immaterial' standard in the proposed rule. The Agencies appear to assume that a 3 percent total is inherently small enough to be immaterial to the soundness of the bank. Were this the case, 'immaterial' would not be specified in the statute.

The agencies should analyze the circumstances under which a total fund investment that amounted to 3 percent or less of Tier 1 capital could still be economically material to the bank. Such circumstances could include a case where the 3 percent investment supports a large flow of

management fees linked to market volatility, as discussed in the Carried Interest section in the discussion of Section _10 above. It could also include a case where funds had significant embedded leverage that could make the bank liable for more than its 3 percent equity stake.

Section 12(c) – Calculation of Aggregate Investment For Covered Funds

As suggested in Question 269, the aggregate investment calculation should directly take into account the underlying leverage of the covered fund. Ideally bank equity exposures to the fund would be scaled up directly with the fund leverage.

Questions 274 and 275 point out that debt interests in securitization vehicles may in effect become an ownership stake in the securitization vehicle, depending on the exact control rights in the trust agreement. In such a case, they should be counted against the aggregate ownership limit.

Section 12(c)(3) – Timing of Aggregate Investment Calculation for Covered Funds

The Proposed Rule states that the aggregate investment calculation for all covered funds shall be calculated as of the last day of each calendar quarter. The specification of a limited number of calendar days for performing the calculation creates vulnerability to "window dressing" practices that conceal the full scope of fund investments, such as occurred with the well-known "Repo 105" transaction at Lehman Brothers. The rule should be changed to specify that aggregate fund investments may at no point exceed 3 percent of tier 1 capital.

Section 12(e) – Extension of Time To Divest an Ownership Interest

The Proposed Rules authorize the Federal Reserve Board to extend the dime for divestment of ownership interests by covered banking entities based on the consideration of certain factors. Among these factors are whether the investment would

> (C) Pose a threat to the safety and soundness of the covered banking entity; or
>
> (D) Pose a threat to the financial stability of the United States….

This standard is misstated. The final rules should articulate these standards in terms of the risk that a threat to safety and soundness or financial stability could result from the continued investment.

Furthermore, the Board is to consider the "cost to the covered banking entity of divesting or disposing of the investment within the applicable period…." This factor is also misstated. The relevant consideration is whether and to what extent the cost of divesting during the applicable period exceeds the cost of divestment during an extension. If it does not, then the extension is unjustified. This should also be changed in the final rule.

Section 13: Other permitted covered fund activities and investments

_13(b): Permitted Risk Mitigating Hedging Activities

The creation of a broad exemption from fund investment limitations for hedging and customer service purposes is problematic and apparently unnecessary. The first prong of this exemption permits the bank to hedge fund exposures taken on behalf of a customer to facilitate the customer's exposure to the profits and losses of the covered fund. Presumably this is meant to cover fiduciary services to customers, as most other forms of customer investment would not require the use of the bank's own book. But the idea that the bank would use its own book to give customers exposure to fund profits or losses runs directly counter to the clear intent of the statute that the bank actively seek additional investors for the fund. In such a case, the customer could gain exposure to the fund simply by making an investment. This should be the bank's primary goal.

The second prong of the hedging exemption would allow the bank to hedge any exposure created by performance-related compensation for a bank employee who was providing asset management services to the fund. This is puzzling in several ways. First, the most straightforward way of implementing such a hedge – simply investing in the fund in proportion to the asset manager's share of profits -- would compensate the bank for payments to asset managers while exposing the bank's shareholders to downside risks of fund losses. This is not a true hedge since the bank's shareholders would assume new risks not reflected in the original compensation. The risks created by any standard type of performance-related compensation are quite different than those created by a fund investment, since the bank is not directly exposed to the downside risk of fund losses.[80] It is unclear whether or how this problem could be handled. In addition, Section _10 already a major exemption for carried interest, which is the most commonly used form of manager compensation. It is unclear why both exemptions would be needed here.

More broadly, introducing the idea that performance-linked compensation is a risk that may be hedged by the bank is a potentially significant loophole in the entire rule. Bank compensation is roughly one third of firm revenue and is linked to capital markets in numerous ways.[81] The idea that banks can engage in such a generalized hedge of its payouts to its own employees will open the door to a whole class of aggregate hedges that will be difficult to control.

These hedge exemptions should be dropped from the final rule. If regulators wish to permit some specific type of performance compensation for fund managers that they believe might be restricted by Section 619, they should straightforwardly permit that type of compensation rather than creating this confusing exemption.

Section 13(d): Loan Securitizations

Here and in Section 14, the Proposed Rule exempts from Section 619 restrictions any bank ownership or sponsorship of a securitization vehicle, so long as the assets owned by such securitization vehicle are limited in particular ways. This exemption contains some positive elements, discussed below. However, it remains problematic in two senses. First, its statutory justification is unclear. According to the Agencies discussion on CFR 68912, it is justified under

[80] The exception is of course when the employee gets a straightforward equity stake in the fund, but that is not the case here.
[81] Luchetti, Aaron, "Wall Street Pay Reaches Record $135 Billion", Wall Street Journal, February 2, 2011.

the 'rule of construction' in Section 13(g)(2) of the BHC Act. However, this rule of construction was intended as a narrow exemption to permit banks, particularly community banks, to sell loans to outside securitizing entities.[82] It was not intended as a broad and generalized exemption for sponsorship of or ownership interests in outside securitization vehicles. This is acknowledged in the Financial Stability Oversight Council's study of Volcker Rule implementation:

> ***Securitization of loans***: The Volcker Rule provides that ―Nothing in this section shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law. In other words, this inviolable rule of construction ensures that the economically essential activity of loan creation is not infringed upon by the Volcker Rule. The *creation and securitization* of loans is a basic and critical mechanism for capital formation and distribution of risk in the banking system. [Emphasis added][83]

Furthermore, the use of the rule of construction for securitizations to shelter this exemption potentially threatens the legal validity of the restrictions placed on securitization in this section. Unlike the 13(d)(1)(J) exemption, the rule of construction does not permit the agencies to specify specific limits on the extent and types of securitization permitted. Instead, the validity of this section rests on the restrictions here being a proper interpretation of the rule of construction reference to 'selling or securitizing loans'.

Second, while the restrictions placed on securitizations here are encouraging and positive in a general conceptual sense, it seems unlikely that they are detailed or extensive enough to permanently restrain the dimensions of securitization that create systemic risk (as discussed in Section _10 above). The rule restricts the assets that may be owned by a securitization vehicle to the following:

> (A) Loans;
>
> (B) Contractual rights or assets directly arising from those loans supporting the asset-backed securities; and
>
> (C) Interest rate or foreign exchange derivatives that:
>
> > (i) Materially relate to the terms of such loans or contractual rights or assets, and
> >
> > (ii) Are used for hedging purposes with respect to the securitization structure

The intention here appears to be to limit bank involvement in securitizations to securitizations of actual loans and accompanying derivatives or contractual rights, thus banning bank involvement in re-securitizations or synthetic securitizations. This is specified in the discussion on CFR 68912 (see footnote 309), which also specifies that credit default swaps could not be held by the

[82] July 15th Merkley/Levin colloquy
[83] Study, page 48.

securitization vehicle. This is a very positive step and we strongly approve of this intention. Synthetic securitizations and resecuritizations were a key contributor to financial contagion during the crisis. There connection to real economy investment is also unclear. It is highly encouraging to see regulators taking concrete steps to limit their use. The restrictions created here are a positive step and a real improvement.

However, the restrictions placed on securitizations remain highly general. As discussed under Section _10 above, the systemic risks posed by securitization are significant. They include concealing the actual quality of underlying collateral risk, creating opaque instruments to avoid proper market assessment and discipline, and enabling regulatory arbitrage. It seems unlikely that these general highly general restrictions would prevent this. For example, the general permission to include contractual rights related to the underlying loans could allow liquidity puts or other complex guarantees from the sponsoring bank (recall that the general exemption granted here to Section 619 restrictions would permit the sponsoring bank to transfer money to the fund). It seems possible to use this exemption to structure hybrid securities that combine secondary cash flows from interest rate swaps or contractual rights with cash flows directly from the underlying loans. Furthermore, the subordination structure of the security could continue to be excessively complex, potentially concealing the true risks from buyers.

As discussed under Section _10 above, if the regulators choose to include a securitization exemption, we would instead recommend a carefully structured 'safe harbor' exemption for particular pre-specified types of securitizations (which could vary by asset class). Such a safe harbor exemption should be placed under the 13(d)(1)(J) permitted activity. Activities must be tightly and thoughtfully restricted to avoid recreating the systemic risks inherent in the unlimited ability to securitize debt and based on particular pre-specified securitization forms that are transparent and standardized. This simple, standardized approach would allow for better market discipline and better regulatory oversight than were seen in securitization markets prior to the crisis.

Section 14: Covered Fund Activities Determined to Be Permissible

The discussion of the securitization exemption in Sections _10 and _13 above also applies to the securitization exemption in _14(a)(2)(v).

Section _17: Other Limitations On Covered Fund Activities

See discussion under Section _8.

Section _20: Program for Monitoring Compliance, Enforcement

The extensive metrics and compliance regime put in place in this rule is appropriate and will be helpful. The great majority of the metrics, measurements, and procedures put in place here should improve bank risk management practices. Entity-level risk management was a serious weakness prior to the crisis, in many cases because top management was not fully aware of the exposures being created by the trading desks. Furthermore, these measurements are not onerous because they are based on existing bank risk management practices and build upon them. For

example, an Oliver Wyman study has found that 14 out of 17 of the risk metrics put in place to monitor permitted trading activities such as market making are already either in wide use today or possible to implement fairly easily using data already collected for internal risk management and P&L purposes.[84]

Should the Agencies feel that steps are necessary to reduce the costs of compliance, there is one simple way to do so while maintaining the entire structure of the compliance program in place. Regulators could require that figures be generated to the accuracy that would be considered effective for high-quality internal risk management purposes, instead of the even higher standard required for external legal reporting. As the trading measurements are metrics in any case, generating such figures with a small error tolerance (the error margin accepted for the best quality internal management) could reduce compliance costs to an even lower level without sacrificing effectiveness.

Question 337. Should proposed rule's Appendix C be revised to require a banking entity's CEO to annually certify that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established pursuant to Appendix C in a manner that is reasonably designed to achieve compliance with section 13 of the BHC Act and this proposal? If so, why? If so, what would be the most useful, efficient method of certification (e.g., a new stand-alone certification, a certification incorporated into an existing form or filing, Web site certification, or certification filed directly with the relevant Agency)? Would a central data repository with a CEO attestation to the Agencies be a preferable approach?

The Agencies should require CEO attestation directly to the agencies that the banking entity was in compliance with Section 619. This attestation should not simply be of the existence of the Appendix C compliance structure, which is after all a means and not the end, but an attestation that the CEO had personally and to the best of his/her ability attempted to ensure the compliance of the banking entity with Section 619 requirements. This would encompass the compliance program, but would also include other, cultural dimensions of Section 619 compliance that cannot be completely captured through metrics. A culture of proprietary trading is quite different than a culture of customer service, and a required attestation by the CEO would ensure that top management was aware that it was their responsibility to maintain such a culture.

A central data repository accessible to all regulatory agencies responsible for enforcing Section 619 is also necessary to ensure regulatory coordination when monitoring the various metrics and ensuring compliance. A major goal of the Dodd Frank Act was to improve regulatory coordination in monitoring and preventing systemic risks, as shown by the creation of the Financial Stability Oversight Committee. Keeping compliance data metrics in separate regulatory 'silos' goes completely counter to this goal.

Section _21: Penalties

[84] Lester, John and Dylan Walsh, "The Volcker Rule Ban On Prop Trading: A Step Closer to Reality", Point of View, Oliver Wyman Company, October, 2011.

Because the statute and proposed rule portend major structural changes for large financial institutions that derived significant profit from proprietary trading and hedge funds, strict enforcement will be important to promote compliance.

The proposed rule restates the statute's provisions regarding penalties, providing in Section 21(b) that if "any banking entity has engaged in an impressible activity the relevant Agency may, after due notice and an opportunity for hearing, direct the banking entity to restrict, limit, or terminate the activity and, as relevant, dispose of the investment." Alone, such a procedure neither holds violators accountable nor deters future infractions, as it imposes no actual penalty beyond a cessation of the activity.

The proposed rule purports to hew to the statutory language under 13e(2), which provides for termination of activities. However, the statute itself provides additional authorities allowing Federal agencies to "further restrict" investments and activities. The Agencies should use this statutory language to impose forceful penalties, such as restrictions on other banking activities. Finally, the Agencies should take advantage of Section 8 of the Bank Holding Company Act that provides criminal penalties for willful violation, and civil penalties for violation by a company or individual of the BHC Act or any association regulation.

We welcome indications that such penalties may be part of the compliance regime from two of the responsible agencies. The Treasury states: "Nothing in this part limits in any way the authority of the OCC to impose penalties for violation." (CFR 68967). The Federal Reserve similarly preserves the right to "impose penalties for violation by any company or individual." (CFR 68968). We ask that the FDIC and the SEC add similar language preserving such authority.

Penalties may not be appropriate immediately upon implementation of the proprietary trading and fund investment restrictions, due to the need to gain experience with measuring permitted activities under Section 619 and develop standards for infractions. However, we request that the the Agencies set a timeline for enumerating and making automatic such penalties. Further, these penalties should be a significant multiple of the value of the profit generated from prohibited activity.

Other Issues – Non-Bank Financial Companies

An effective implementation of Section 619 will of course create incentives for major banks to push proprietary risks off their own books and for such risks to be taken by entities outside the core banking system. If such entities are small enough and sufficiently equity-based to be able to fail without wider systemic effects then this could and should be a major benefit of the rule.

However, a clear lesson of the 2008 experience is that such non-banking entities can end up performing credit intermediation that is central to the economy, and thus may be systemically significant in case of a crisis. It is of course true that many of the key broker-dealers who

received Federal assistance during the financial crisis did not have bank holding company status (although most have adopted it since that time). It will be a significant issue if Section 619 results in risk migration to a shadow banking system that is both economically central and less subject to regulation.

Fortunately the scope of Section 619 is not limited to the banking entities covered by this rulemaking. Section 13(a)(2) of the Bank Holding Company Act provides as follows:

> NONBANK FINANCIAL COMPANIES SUPERVISED BY THE BOARD.—Any nonbank financial company supervised by the Board that engages in proprietary trading or takes or retains any equity, partnership, or other ownership interest in or sponsors a hedge fund or a private equity fund shall be subject, by rule, as provided in subsection (b)(2), to additional capital requirements for and additional quantitative limits with regards *to* such proprietary trading and taking or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or a private equity fund, except that permitted activities as described in subsection (d) shall not be subject to the additional capital and additional quantitative limits except as provided in subsection (d)(3), as if the nonbank financial company supervised by the Board were a banking entity.

The reason for this provision is made clear in the legislative history of Section 619.

> Section 619 is intended to limit proprietary trading by banking entities and systemically significant nonbank financial companies… Given the varied nature of such nonbank financial companies, for some of which proprietary trading is effectively their business, an outright statutory prohibition on such trading was not warranted. Instead, the risks posed by their proprietary trading is addressed through robust capital charges and quantitative limits that increase with the size, interconnectedness, and systemic importance of business functions of the nonbank financial firm. These restrictions should become stricter as size, leverage, and other factors increase. As with banking entities, these restrictions should also help reduce the size and risk of these financial firms.[85]

This significantly illuminates the intended Approach to be taken by the Agencies in implementing the provisions of Section 619 relating to non-bank financial companies. As a threshold matter, the systemic risk posed by proprietary trading and hedge fund and private equity fund investment by both banking entities and non-bank financial companies is seen as an integrated problem. Such activity undertaken by systemically significant non-bank financial companies should also be restricted. This is a function of size, interconnectedness and systemic importance of business functions. However, the problems for banking entities and their solutions are different.

A true assessment of the Proposed Rules cannot be fully made unless the system of capital charges and quantitative limits applicable to non-bank financial companies can be understood to

provide proper context. The two sets of rules really constitute a single regulatory fabric, as the issue of risk migration created by the enforcement of Section 619 for banks cannot be fully understood until the 13(a)(2) provisions covering non-banks are in place.

Unfortunately, 13(a)(2) is not implemented in this Notice of Proposed Rulemaking, and no date has been given as to when it will be implemented. In order for the final rules to provide credible assurance as to the protection from a recurrence of the tragedy of 2008, the agencies must do a rulemaking on regulation of non-bank financial company capital charges and quantitative limits. The Agencies should move rapidly to this proposal, or at minimum state the timeline for completing the proposal.

Thank you for the opportunity to comment on this rule. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,

AFL-CIO

Americans for Financial Reform

U.S. PIRG

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85 Congressional Record, 111th Congress, July 15, 2010, pages S5894-5, Remarks of Senator Merkley.

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action

- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense

- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio

- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN

- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG

- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET