February 10, 2012

Department of the Treasury
Office of the Comptroller of the Currency
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Robert E. Feldman
Executive Secretary, Attention: Comments
Federal Deposit Insurance Corporation
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Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
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Securities and Exchange Commission
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Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Docket ID OCC-2011-14, Docket No. R-1432, RIN 3064-AD85, SEC File No. S7-41-11)

Ladies and Gentlemen:

The Committee on Investment of Employee Benefit Assets ("CIEBA") appreciates the opportunity to provide comments to the Office of the Comptroller of the Currency, Department of Treasury ("OCC"); Board of Governors of the Federal Reserve System ("Board"); Federal Deposit Insurance Corporation ("FDIC"); and Securities and Exchange Commission ("SEC") (collectively, the "Agencies") regarding the recently released notice of proposed rulemaking and request for comments ("NPRM" or "proposed rule") concerning the proposed rule to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company supervised by the Board to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund.

CIEBA represents more than 100 of the country's largest pension funds. Its members manage more than $1.5 trillion of defined benefit and defined contribution plan assets on behalf of 17 million plan participants and beneficiaries. CIEBA members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets.

Summary

CIEBA is very concerned about the market making exception in the proposed rule. Rather than encouraging or facilitating market making activities, the proposed rule will discourage banking entities from holding inventory and thus will discourage them from acting as market-makers. The consequence will be reduced liquidity in financial markets, which will cause significant harm to the real economy and employment. This will exacerbate existing economic problems: market conditions remain uncertain, unemployment remains at levels unprecedented in decades,

and market liquidity is still far below levels seen in the years before the financial crisis. The capital requirements being imposed under Basel III and the numerous regulatory requirements under the Dodd-Frank Act are already causing banks to reduce their market making activities. The proposed rule will make a bad liquidity and economic environment even worse. Ultimately, the real losers will be investors such as pension plans and their beneficiaries, which could see the value of their instruments decline as a result of liquidity shortages, and the small issuers that have been drivers of employment growth. For smaller issuers in particular, market makers need to have incentives to make markets. The proposed rule removes important incentives for banking entities to act as market makers and, in our opinion, has a punitive focus on market making. Even sovereign issuers have complained about the impact of the Volcker rule on the liquidity of their securities.[1] The potential impact on the ability of smaller issuers to bring their securities to market and fund necessary economic growth will be even greater. Accordingly, we urge the agencies to recognize the negative consequences of the proposed rule, which was intended to limit the proprietary trading of banking entities but will instead limit market making, and as a result negatively impact the markets and market participants such as pension funds.

We specifically urge the Agencies to make the following changes to the criteria for the market making exemption:

- **Remove the requirement that income from market making be generated primarily from fees, commissions and spreads, instead of appreciation in the value of positions.** The proposed requirement is unrealistic, because banking entities have no control over the appreciation in value of assets held for market making inventory. As proposed, the rule will result in significantly less liquidity and higher fees/spreads for investors and issuers. The rule's negative impact will be felt most acutely during a market crisis and could precipitate a "death spiral" of illiquidity and price declines.

- **Delete the requirement that a trading desk be willing to buy and sell on a regular or continuous basis for every type of instrument including illiquid securities, and instead require that the market making entity, for any asset class, must hold itself out *generally* as a market-maker but is not required to do so for every instrument which it purchases or sells.** The purpose of market making is to provide liquidity, which cannot always occur, especially in illiquid markets and for illiquid instruments, on a regular or continuous basis.

- **Broadly interpret the requirement that a trading desk limit its market making activity to "reasonably expected near term demand".** While this is a statutory criterion, the rule must specifically interpret the requirement differently for illiquid instruments. Because of the proposed restrictions, banking entities will err on the side of holding less inventory instead of facing sanctions for violating the regulatory restriction.

[1] Comment Letter from George Osborne, Chancellor of the Exchequer, United Kingdom to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System (Jan. 23, 2012). Chancellor Osborne notes that the proposed rule would "make it more difficult and costlier to provide market-making services in non-US sovereign markets. Any consequent withdrawal of market-making services by banks would reduce liquidity in sovereign markets, which in turn would engender greater volatility and make it more difficult, riskier and costlier for countries such as the UK to issue and distribute their debt". *See also*, Comment Letter from Bank of Japan and Japanese Financial Services Agency to the Agencies (Dec. 28, 2011).

I. The Agencies should remove the requirement that income from market making be generated primarily from fees, commissions and spreads, instead of appreciation in the value of positions. As proposed the rule will result in less liquidity and higher fees/spreads for investors and issuers.

The proposed requirement is unrealistic, and assumes that banking entities have control over the appreciation/depreciation in the value of a particular asset held for inventory. Because banking entities do not have control over whether an asset appreciates, to avoid violating the rule that they not make more from the appreciation of an asset than the spread or commissions received in the purchase of an instrument, banking entities will quickly move to either hedge or sell instruments or to not buy instruments which cannot be quickly sold or hedged. As a result, the rule will have the practical effect of discouraging market makers from holding inventory, a critical element to market making, and will have the unintended consequence of reducing liquidity for investors and issuers. Ironically, the rule is internally inconsistent in its policy objectives because the less inventory that banking entities have, the less they can make from fees, commissions and spreads as compared to appreciation from the sale of such inventory.

Market making involves the purchase and sale of financial instruments and the holding of inventory to meet expected demand. However, market makers will not always be compensated for holding inventory by fees, commissions or spreads. For principal-to-principal markets, such as most of the fixed-income markets, a market maker will purchase the asset as principal and therefore will not earn fees or commissions. As pointed out in a recent article, the ability of market making entities to absorb unexpectedly large supply and demand imbalances depends on the incentive of market making entities to profit from expected changes in the value of their positions.[2] Without such an incentive, future strains on liquidity will be further exacerbated by the unwillingness of market making entities to step in and buffer imbalances. Thus, the effect of the proposed rule will be to significantly restrict the ability of banking entities to provide liquidity in markets which do not have a large population of ready buyers and sellers. Moreover, in order to be compensated for market-making if appreciation of value is not a permissible goal, banking entities are likely to widen spreads and impose higher fees.

Also, even with higher fees/spreads, banking entities will be reluctant to provide any liquidity for illiquid instruments because, unless they can immediately hedge or sell the instrument, they run the risk of violating the law if the asset appreciates during the period that it is held in inventory. Recent data shows that for 47% of US corporate bonds that traded in 2009, trading occurred on only zero to ten days throughout the year.[3] Given this low frequency of trading in fixed-income instruments, it is not always possible for banking entities to promptly buy and sell positions and thus generate income from the spread. The rule's impact on liquidity is not limited to illiquid instruments; even large issuers of liquid instruments such as sovereign issuers have objected to the rule's potential negative impact on the market for such instruments.[4]

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[2] Darrel Duffie, *Market Making Under the Proposed Volcker Rule*, Jan. 16, 2012, at 19.

[3] *See* Oliver Wyman, *The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity*, Feb. 2012, at 9 (analysis of FINRA TRACE data).

[4] *Supra*, note 1.

Another critical concern for pension plans is the effect that the proposed market-making restrictions will have on the liquidity of customized swaps. Pension plans use swaps to manage risk resulting from the inherent volatility of the present value of their specific liabilities to plan beneficiaries. Unless pension plans are able to enter into customized swaps, they may be unable to effectively reduce the risk of becoming underfunded or subject to sudden increases in cash obligations to beneficiaries. For customized swaps, it will be difficult for a market-maker to enter promptly into an offsetting swap, so the market-maker would not be able to generate income from the spread, as envisioned by the proposed regulation. As a result, the proposed criteria would make it more difficult for a pension plan to hedge the risks of its unique portfolio with customized swaps.

This issue will particularly be a problem in a crisis situation. Market makers are most needed in order to meet demands in stressed situations when participants are faced with a shortage of liquidity in the market. Yet, in that situation, the market-maker is unlikely to find another party who will readily take an offsetting position. In the absence of an offsetting position, the market maker will only be compensated for principal trades by appreciation in their value. As a result, the market-making rule will have the perverse consequence of discouraging market-makers at the time when they are most needed to provide liquidity. In a falling market, there are more sellers than buyers. If, in a falling market, market makers were concerned that they could violate law by providing liquidity for instruments that they may need to hold in order to avoid losses, they will be reluctant to provide that liquidity. As a result, in a stressed market environment such as the one experienced in the fall of 2008, the proposed rule could have the unintended consequence of precipitating a death spiral of illiquidity and price declines.

II. The Agencies should delete the requirement that a trading desk be willing to buy and sell on a regular or continuous basis for every type of instrument including illiquid securities, and instead require that the market making entity, for any asset class, must hold itself out *generally* as a market-maker but is not required to do so for every instrument it purchases or sells.

The Agencies acknowledge in the NPRM that the indicia of appropriate market making-related activity in illiquid markets may be markedly distinct from those in liquid markets.[5] The release states that market making in a highly illiquid market may occur "only by appointment".[6] However, even for illiquid markets, the proposed rule would require a trading desk seeking to act under the market making exemption to buy and sell on a regular basis. The proposed rule fails to provide clarity or guidance on the meaning of "regular" in this instance. Certainly, trading only by appointment in illiquid markets would not qualify as "regular". Even a dictionary definition of "regular" would require trading to occur at fixed, periodic intervals. This is illogical in an illiquid market where trading may only occur by appointment.[7]

Instead of including criteria that cannot be meaningfully applied, the proposal should simply require that the market maker hold itself out as generally willing to buy and sell as part of its

[5] 76 FR 68846 at 68871.

[6] 76 FR 68846 at 68871. fn. 149.

[7] *See* Duffie at 9 (for the proposition that, "[p]articularly in fixed-income markets. trades are widely and unpredictably spaced in time, and sometimes are effectively 'by appointment'".).

business of market making. Currently, a banking entity may provide a highly structured, negotiated transaction with an investor in order for the investor to hedge the assets of its beneficiaries. Such a client-facing transaction should be permitted as market making beneficial to clients. However, with a rigid application of the "regular or continuous" criteria, this transaction may be prohibited under the proposed rule.

III. The Agencies should broadly interpret the requirement that a trading desk limit its market making activity to "reasonably expected near term demand," which a market maker will not be able to approximate, particularly in illiquid markets.

The proposed rule interprets the phrase "reasonably expected near term demands of clients, customers, or counterparties" too narrowly.[8] Liquidity needs of pension funds and other market participants do not follow a pattern that is in all instances predictable by the funds themselves, much less by liquidity providers. Changing market conditions require pension funds and other market participants to continuously reassess their liquidity needs. The proposed release permits *bona fide* market making related activity to include taking positions in securities in anticipation of customer demand, but only if "anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties."[9] Guidance in the proposed release further provides that in order for a banking entity's expectation of demand to be considered reasonable, expectations should "be based on the unique customer base of the banking entity's specific market making business lines and the near-term demands of those customers based on particular factors beyond a general expectation of price appreciation."[10] This requirement, coupled with the Agencies' guidance, would require a banking entity to only hold assets that are specifically tied to clear, demonstrable client trading interest and would not permit additional holdings to be deemed "made in connection with market making-related activity".

Such a narrow reading is not required by the statute, and would pose logistical problems if the demand for liquidity deviates from what could be classified as reasonably expected near-term demand. The rule would serve to threaten banking entities with regulatory sanctions for failing to accurately measure their clients' future demands (even though their clients may not be able to predict their own demands). Banking entities which gain or lose customers and thus miss their "targeted client demand" numbers would be subject to regulatory sanctions for "too much" or "too little" business. Banking entities could be afraid to provide liquidity in a market crisis or to take new customers on to avoid overshooting their "targeted client demand" numbers. These unintended consequences would defeat the purpose of the market making exemption.

The criteria in the proposed rule will lead to the perverse result that banking entities will severely limit their market making inventories and will only provide a market making function if there is a buyer to which the banking entity can immediately offload its position. Therefore, we urge the Agencies to clearly provide that "reasonably expected near term demand" does not preclude the holding of inventory by a market making entity, as long as that inventory will *generally* be used for market making-related activities.

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[8] 76 FR 68846 at 68871

[9] 76 FR 68846 at 68871.

[10] 76 FR 68846 at 68871.

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We thank the Agencies for the opportunity to comment on its NPRM on the prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds.

THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS