# Occupy the SEC

http://www.occupythesec.org

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**Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in and Relationships With, Hedge Funds and Private Equity Funds (RIN 1557-AD44; RIN 7100 AD 82; RIN 3064-AD85; RIN 3235-AL07)**

Dear Sirs and Madam:

Occupy the SEC[1] submits this comment letter in response to the above-mentioned regulatory agencies' ("Agencies") notice of Proposed Rulemaking ("NPR", "Proposed Rule")[2] implementing Section 619 of the Dodd-Frank Act ("the Act").[3]

Occupy the SEC is a group of concerned citizens, activists, and financial professionals with decades of collective experience working at many of the largest financial firms in the industry. Together, we make up a vast array of specialists, including traders, quantitative analysts, compliance officers, and technology and risk analysts. Like much of the 99%, we have bank deposits and retirement accounts that are in need of protection through vigorous enforcement of

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[1] Occupy the SEC (http://occupythesec.org) is a group within the New York-based Occupy Wall Street ("OWS") protest movement. This letter represents the opinion of our group's members, and does not represent the viewpoints of OWS as a whole. Our members include Akshat Tewary, Alexis Goldstein, Corley Miller, George Bailey, Caitlin Kline, Elizabeth K. Friedrich, Eric Taylor, and others.

[2] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011) [hereinafter NPR or Proposed Rule].

[3] 12 U.S.C. § 1851 (2011).

the Volcker Rule. Our experiences working inside the financial industry have informed our answers to the questions proposed, making us well-suited to understand and anticipate how the proposed implementation, should it stand, will affect us and the rest of the general public.

The United States aspires to democracy, but no true democracy is attainable when the process is determined by economic power.[4] Accordingly, Occupy the SEC is delighted to participate in the public comment process for the implementation of Section 619 of the Dodd-Frank Act by the SEC, Federal Reserve, OCC and FDIC ("the Agencies"). This country's governing principles of transparency and due process mandate that any rules implemented by our regulators comport with the democratically-elected legislature's intention to protect the people from the widespread banking abuses and excesses of the recent past. We believe the Volcker Rule is important to the future of the banking industry and, if strongly enforced, will help move our financial system in a more fair, transparent, and sustainable direction. Prohibiting banking entities from engaging in proprietary trading and banning their sponsorship of covered funds are key elements to regulating the financial system and giving force to the Dodd-Frank Act. At its core, the Volcker Rule seeks to make sure that if a banking entity fails, it does not bring down the whole system with it. We appreciate the momentous challenges that the Agencies continue to face in effectively implementing the Rule, and we present these comments to assist them in their task.

This letter contains a summary of our positions. *Annexure A* hereto contains more detailed answers to 244 of the 395 questions asked by the Agencies. Any questions that remain unanswered in *Annexure A* should be interpreted by the Agencies as our suggestion that the applicable provision in the Proposed Rule remain unchanged. *Annexure B* contains a proposed markup of various sections of the Text of the Proposed Rule, and *Annexure C* contains a proposed markup of the Commentary Regarding Identification of Permitted Market Making–Related Activities, which appeared as Appendix B to the Proposed Rule.

[4] Occupy Wall Street, Declaration of the Occupation of New York City (2011), http://www.nycga.net/resources/declaration/.

## I. INTRODUCTORY COMMENTS

Proprietary trading by large-scale banks was a principal cause of the recent financial crisis,[5] and, if left unchecked, it has the potential to cause even worse crises in the future. In the words of a banking insider, Michael Madden, a former Lehman Brothers executive:

> Proprietary trading played a big role in manufacturing the CDOs and other instruments that were at the heart of the financial crisis. . . . If firms weren't able to buy up the parts of these deals that wouldn't sell . . . the game would have stopped a lot sooner.[6]

The interconnectedness of banks under the shadow banking system had the effect of magnifying one bank's proprietary trading losses (e.g., Lehman Brothers) and transferring them across the market as a whole. Lobbyists' exhortations notwithstanding, proprietary trading by government-backstopped banks is a fundamentally speculative and risky phenomenon that must be circumscribed.

During the legislative process, the Volcker Rule was woefully enfeebled by the addition of numerous loopholes and exceptions. The banking lobby exerted inordinate influence on Congress and succeeded in diluting the statute, despite the catastrophic failures that bank policies have produced and continue to produce.[7] Nevertheless, the Volcker Rule, in its current statutory form still has the potential to rein in certain speculative trading practices by banking entities that enjoy ready access to customer deposits and virtually limitless funding through various Federal Reserve programs. We encourage the Agencies to stand strong against the flood of deregulatory pressure that they have and will continue to face in connection with their implementation of the Volcker Rule. A vigorously implemented and enforced Volcker Rule would serve as insurance against the need for future bank bailouts funded by taxpayers.[8] The Agencies must take advantage of this historic opportunity to protect the financial position of the average person living in the United States.

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[5] *See, e.g.*, Jeff Merkley, U.S. Senator and Carl Levin, U.S. Senator, *Making the Dodd—Frank Act Restrictions on Proprietary Trading & Conflicts of Interest Work*, Roosevelt Institute, *available at* http://www.rooseveltinstitute.org/sites/all/files/Will_It_Work_Proprietary_Trading.pdf. This view has been echoed across academia. For instance, Jeremy Berkowitz, a finance professor at the University of Houston noted that "[t]o a certain extent, proprietary trading was the key driving force that was behind the disaster. For whatever the reason, Lehman and other banks decided to take positions in mortgages, and when those positions went south, so did the firms." Stephen Gandel, *Is Proprietary Trading Too Wild for Wall Street?*, Time, Feb. 5, 2010, *available at* http://www.time.com/time/business/article/0,8599,1960565,00.html#ixzz1kuiacUK. *See also* Gerald Epstein, The Volcker Rule: Rule Implementation Issues and Study Guide, SAFER Policy Brief (Oct. 4, 2010) ("Appropriate, forceful implementation of these provisions is crucial for helping to avoid future economic crisis.").

[6] Gandel, *supra* note 5.

[7] *See* Occupy Wall Street, *supra* note 4.

[8] 156 Cong. Rec. S5893 (daily ed. July 15, 2010) (statement of Sen. Conrad).

## A. The Agencies' Lax Regulatory Posture

The Agencies have been universally lambasted, by banks, by advocacy groups, by Congress, and by the media, for promulgating a Proposed Rule that is a 500-page web of complexity.[9] Even former Federal Reserve Chairman Paul Volcker, the Rule's namesake, has criticized the Proposed Rule for its length.[10] To some extent, the Proposed Rule's length is to be expected because the statute it implements, Section 619 of the Dodd-Frank Act, is itself replete with loopholes, exemptions and limitations. Even so, in issuing implementing regulations, the Agencies have avoided simple, bright-line rules that could have clearly delineated exactly what is and is not permissible under the statute. As discussed below, the Agencies have sadly eschewed clarity, instead muddying the regulatory waters with multi-factor tests, a vague intentionality requirement, newly created loopholes and exemptions, and definitional uncertainty. The absence of bright-line rules was not a happenstance or an unintended consequence; it was a conscious choice that evinces a lax regulatory posture among the Agencies. Federal Reserve Governor Daniel Tarullo recently testified before the Congressional Financial Services Committee that the Proposed Rule was designed to avoid "definitive bright lines" in favor of a "more nuanced framework."[11] We advise the Federal Reserve and the other Agencies not to confuse mere complexity for nuance. Simple bright-line rules make the compliance process easier, both for the regulated and for the regulator.

Another troubling element within the Proposed Rule is the Agencies' *ultra vires* interposition of an intentionality requirement into various aspects of the Proposed Rule, despite the complete absence of any explicit intentionality safe harbor in Section 619. Securities and Exchange Commission Chairman Mary Schapiro told the Financial Services Committee that "[w]e have no interest in pursuing activity where people are *intending* to provide market-making and get it wrong."[12] The banking lobby was undoubtedly heartened by this frank admission of regulatory forbearance. Even so, the Securities and Exchange Commission ("SEC") and the other Agencies are reminded that Section 619 requires strict compliance and imposes strict liability. ***Nowhere does the statute forgive "well-intentioned" breaches of the law.***

The Proposed Rule also evinces a remarkable solicitude for the interests of banking corporations over those of investors, consumers, taxpayers and other human beings. In their Overview of the Proposed Rule, "the Agencies request comment on the potential impacts the proposed approach may have on banking entities and the businesses in which they engage,"[13] but curiously fail to solicit comment on the potential impact on consumers, depositors, or taxpayers. The Administrative Procedure Act requires that, prior to the enactment of a substantive regulation, an

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[9] James B. Stewart. *Volcker Rule, Once Simple, Now Boggles*, N.Y. Times, Oct. 21, 2011. *available at* http://www.nytimes.com/2011/10/22/business/volcker-rule-grows-from-simple-to-complex.html?_r=1&pagewanted=all.

[10] *Id.* ("I'd love to see a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance.").

[11] Phil Mattingly & Cheyenne Hopkins. *Volcker Rule Regulators Resist Lawmakers Calls to Scrap Proposal*. Bloomberg BusinessWeek, Jan. 24, 2012, *available at* http://www.businessweek.com/news/2012-01-24/volcker-rule-regulators-resist-lawmakers-calls-to-scrap-proposal.html.

[12] *Id.* (emphasis added).

[13] NPR at 66,849.

agency must give "interested persons" an opportunity to comment.[14] The Agencies seem to have lost sight of the fact that "interested persons" could include human beings, and not just banking corporations.

We are not flippantly criticizing the Agencies for having a lax regulatory posture in their implementation of Section 619. We are basing our concerns on the regulators' own words, as noted above, and as discussed in detail below.

### B. The Absence of Penalties in the Proposed Rule

The Agencies have inherent authority to impose automatic penalties and fines for certain proscribed activities, and Section 619 does not impinge on that authority:

> Nothing in this paragraph shall be construed to limit the inherent authority of any Federal agency or State regulatory authority to further restrict any investments or activities under otherwise applicable provisions of law.[15]

Nevertheless, the Proposed Rule fails to define any automatic penalties or fines for violations of the restriction on proprietary trading. We are cognizant of the fact that Section 8 of the Bank Holding Company Act already contains a general framework for criminal and civil penalties. Nevertheless, the Agencies have the ability to define particular penalties for specific violations of the Volcker Rule, and they should consider doing so while drafting the Final Rule.

### C. The Need for a Strong Volcker Rule

The passage of the Gramm-Leach-Bliley Act and other deregulatory actions taken by Congress and the financial regulators in the last 15 years have frozen up capital and stultified the economy, especially from the perspective of the average American.

Free from the enforced separation between commercial and investment banking, as originally required by the Glass-Steagall Act, banks now prefer to engage in self-interested proprietary trading rather than pursuing traditional banking activities that actually promote true "liquidity" across markets. Liquidity in opaque financial instruments may have increased in recent years, but real liquidity, which benefits consumers, investors, small business owners, and homeowners, has not followed suit. The inflation-adjusted Dow Jones Industrial Average is around the same level that it was in the mid-to-late 1990's.[16] Similarly, the income of the typical American family is at the same level that it was in 1996.[17] However, unlike in 1996, over 28% of American homes are "underwater."[18] The banking lobby's elixir, financial market liquidity, has done little to

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[14] 5 U.S.C. § 553(c) (2011).
[15] 12 U.S.C. § 1851(e).
[16] E.S. Browning, *Adjusted for Inflation, Dow's Gains Are Puny*, Wall St. J., Dec. 28, 2009.
[17] Conor Dougherty, *Income Slides to 1996 Levels*, Wall St. J., Sep. 14, 2011.
[18] John Gittelsohn, *U.S. 'Underwater' Homeowners Increase to 28 Percent, Zillow Says*, Bloomberg, May 9, 2011, *available at* http://www.bloomberg.com/news/2011-05-09/u-s-underwater-homeowners-increase-to-28-percent-zillow-says.html.

reverse this trend. We therefore urge the Agencies to take banks' animadversions regarding "liquidity" with a grain of salt.

Certain commentators have opined that the Volcker Rule puts American banks at a global disadvantage. However, stable, customer-focused banks actually enjoy a competitive advantage as they are freed from the shackles of risk attendant to proprietary trading activities. This competitive advantage will create a first-mover advantage for American banks that pursue less risky, more productive activities. Foreign banks that continue to conduct proprietary trading will fail at higher rates, thereby undermining their competitiveness.

Much of the criticism levied upon the Agencies by Canadian, Japanese, and European banks and regulators has been unwarranted. As the Agencies are aware, the Volcker Rule does not prohibit proprietary trading activities outright. Rather, the Rule only restricts banks that have an implicit government insurance policy from engaging in such activities. The "invisible hand of the free market," that darling cherub of neoliberal economics, will likely push much of the current proprietary trading into the folds of hedge funds or traditional investment banks, not eliminate them outright (assuming, of course, that such activities actually add productive value to the economy). The Volcker Rule simply removes the government's all-too-visible hand from underneath the pampered haunches of banking conglomerates.

# II. DEFINITIONAL ISSUES

## A. Covered Financial Position

### 1. Definition of Loans

The Proposed Rule's definition of "covered financial position" is imprecise in its delineation of "loans," which are excluded from the scope of the Volcker Rule.[19] The current definition implies that securities, derivatives, and commodity futures are not considered loans. However, this distinction should be made explicit, clarifying that any "loan" with the properties of a commodity[20] or security would qualify as a covered financial position. We propose that the definition of loan at § _.2(q) be modified to read as follows:

> (q) Loan means any loan, lease, extension of credit, or secured or unsecured receivable. *A loan shall not mean a position:*
>
> 1. *having the expectation of profits arising from a common enterprise which depends solely on the efforts of a promoter or third party,*[21]
> 2. *in which there is common trading for speculation or investment,*[22]
> 3. *that materially has the characteristics of a commodity, security, or derivative, or*
> 4. *that falls within the scope of § _.3(b)(3)(i)*

While there is overlap in some of these definitions, such overlap will be practically useful as it will reinforce to reviewing courts, the Agencies, and compliance officers the bounds of what is and is not covered by the Volcker Rule.

For instance, one law firm has suggested that the current version of the Proposed Rule would not restrict a banking entity's ability to use an "intercompany loan" as a means to approximate an "ownership interest" in a securitization Special Purpose Vehicle ("SPV").[23] That is, the Volcker Rule's restrictions on "ownership interest" can be evaded by structuring an interest in an SPV as an intercompany "loan" and not ownership *per se*.

In a more straightforward securitization, the banking entity has an ownership interest in the SPV, and therefore gains risk exposure to the asset pool underlying the transaction. The same result can be achieved by using an intercompany loan, such that the bank loans money to the SPV, and is repaid its money by the SPV based only on the performance of the underlying asset pool.[24] In

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[19] Proposed Rule § _.3(b)(3)(ii)(A).

[20] As discussed below, commodities should be included as covered financial positions.

[21] This language derives from *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293 (1946).

[22] This language derives from *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990).

[23] Allen & Overy, What's in a Name? The Volcker Rule's Impact on ABS Issuers that are Covered Funds. Nov. 17, 2011. http://clientlink.allenovery.com/images/What%27s_in_a_Name_The_Volcker_Rule%27s_Impact_on_ABS_Issuers_that_are_Covered_Funds.pdf (last visited Jan. 2, 2012).

[24] *See* Vinod Kothari, Covered Bonds in Asia 9-10 (1st ed. 2006), *available at* http://www.vinodkothari.com/Covered%20Bonds%20in%20Asia.pdf. In such a structure, the loan repayment

either scenario, the banking entity's income stream is dependent on the timely and regular flow of funds from the underlying assets. However, the latter structure, ostensibly a "loan," would fall outside the purview of the Proposed Rule in its current form. Our proposed modification at § _.2(q)(1) or (2) would foreclose a banking entity's ability to evade the Volcker Rule's restrictions by using so-called loans as conduits for proprietary positions.

Further, the Proposed Rule in its current form could allow banking entities to engage in active trading of unpooled, large-scale commercial loans for purely speculative purposes. Our revised definition at § _.2(q)(2) would make any financial position that is actively traded for speculation or investment a covered financial position, even if that position is nominally designated as a "loan."

### 2. The Exclusion of Commodities

The Proposed Rule's exclusion of commodities from covered financial positions is troubling. The statute defines proprietary trading to include transactions in:

> any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.[25]

Admittedly, Section 619(h)(4) does not explicitly include spot commodities, instead referring to commodity futures and forwards. Nevertheless, the same section grants the Agencies the authority to bring commodities into the Volcker Rule's ambit. The Agencies should utilize that authority, as it appears that the exclusion of the word "commodity" from the statute was an oversight. In the Congressional Record, Senator Merkley stated that the intent behind Section 619 was to define proprietary trading to cover "**a wide range** of financial instruments, including securities, **commodities**, futures, options, derivatives, and **any similar financial instruments**."[26] The expansive breadth of this language also militates in favor of the inclusion of foreign exchange and currency positions. Accordingly, we recommend that the Agencies entirely remove Proposed Rule §§ _.3(b)(3)(ii)(B) and (C).

This removal is also necessary because the definition of "covered financial position" under the Volcker Rule does not match the definition of "covered position" under the Market Risk Capital Rule, which explicitly includes all positions in a trading account, "and all foreign exchange and commodity positions, whether or not they are in the trading account."[27] As noted elsewhere in the Proposed Rule, the Market Risk Capital Rules have a high degree of relevance as to what is and is not covered by the Volcker Rule, specifically with respect to the definition of "trading

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obligations of the banking entity can be tailored to match the debt profile in the SPV's asset-backed securities. *See* Vinod Kothari, Securitization: The Financial Instrument of the Future 348 (1st ed. 2006).

[25] 12 U.S.C. § 1851(h)(4).

[26] 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Levin) (emphases added).

[27] Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890, 1892 (proposed Jan. 11, 2011).

account." Thus, the Agencies create undue ambiguity by imposing two different standards in related rules. A decision by an administrative agency that is based on a rationale that is internally inconsistent or incoherent will be set aside.[28]

Proprietary trading strategies can be used with virtually any financial instrument, and abusive practices will migrate to under-regulated markets as banking entities respond to the new incentives created by the Volcker Rule. This migration could cause serious disruptions to previously well-functioning markets. Thus, we recommend that the Agencies broaden the scope of covered financial positions, as described here, in order to retain visibility over new and currently-underutilized asset classes that can become conduits for proprietary trading.

## B. Scope of Entities Included in Covered Fund Definition

### 1. Statute's Intent

The Volcker statute states that the Agencies have the authority to expand the scope of "covered fund." Section 13(h)(2) of the Bank Holding Company Act ("BHC Act") states that 3(c)(1) and 3(c)(7) funds "or such similar funds as the appropriate Federal banking agencies . . . may . . . determine" all fall under the definition of covered fund. In fact, the Financial Stability Oversight Council ("FSOC") has specifically recommended that the Agencies utilize this authority to broaden the scope of covered fund beyond a definition tied to 3(c)(1) and 3(c)(7):

> [T]he Council recommends that Agencies consider using their authority to expand the definition by rule to funds that do not rely on the section 3(c)(1) and 3(c)(7) exclusions, but that engage in the activities or have the characteristics of a traditional private equity fund or hedge fund.[29]

We encourage the Agencies to adopt a qualitative definition of "covered fund." This interpretation would facilitate the effective policing of any fund that engages in proprietary trading activity. Given the ingenuity banks and their lawyers have shown in the past in evading quantitative criteria for regulation, we recommend that the Agencies include a catch-all qualitative category of covered fund. This qualitative category would include any subsidiary entity that exhibits the characteristics of a fund that takes on proprietary trading activities. In brief, if a fund can devote any portion of its activities to proprietary trading activity, then the Agencies should be able to consider it a covered fund. Moreover, the definition should be additive, such that it defines a covered fund as a fund exempted by 3(c)(1) or 3(c)(7), **or** any other fund that engages in proprietary trading beyond a *de minimis* level. We have outlined these suggested modifications in *Annexure B*.

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[28] *Motor Vehicles Mfgs. Ass'n v. State Farm Mutual Auto Ins. Co.*, 463 U.S. 29, 43 (1983) (requiring agencies to show a rational connection between the facts found and the choice made).

[29] Financial Stability Oversight Council, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds 62 (Jan. 18, 2011) (emphasis added), *available at* http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf [hereinafter FSOC Study].

### 2. Commodity Pools

Commodity Pools are hedge funds and should be treated as such. The CFTC has in the past regarded many commodity pools as hedge funds, and we applaud the Rule's inclusion of commodity pools as covered funds.

### 3. Broker-Dealers

We are concerned that covered funds can take the form of broker-dealers (exempted under section 3(c)(2) of the Investment Company Act) and maintain a majority of assets in government securities, avail of the Rule 3a-1 or Rule 3a-6 exemption, or avail of an explicit exemptive order, and in doing so carry out proprietary trading through that fund free of the Volcker Rule's limitations. According to Rule 3a-1 or Rule 3a-6 of the Rules and Regulations promulgated under the Investment Company Act, a prima facie exclusion is created from the Investment Company Act if 55% or more of a fund's value is stored in government securities and other non-investment securities. In other words, a fund can avail of the 3a-1 exclusion despite devoting up to 45% of its assets to explicit proprietary trading.

Unless the 3a-1 exclusion is brought within the remit of the Volcker Rule, a banking entity could purchase a fund availing of this exclusion to conduct extensive proprietary trading (up to 45% of the fund) free of the Volcker Rule's prohibitions.

We recognize that a 3(c)(2) broker dealer is required to be "primarily engaged" in customer-focused activities.[30] However, the current interpretation of "primarily engaged" would create an enormous loophole for banking entities to skirt the covered fund restrictions. A fund can still avail of the 3(c)(2) exemption while devoting up to 45% of its assets to explicit proprietary trading.[31] Unless 3(c)(2) broker-dealer funds are brought within the purview of the Volcker Rule, a banking entity could purchase such a fund as a subsidiary, and conduct extensive proprietary trading (up to 45% of the fund) free of the Volcker Rule's prohibitions.

### 4. Foreign Banks

Foreign banks exempted under 3(a)(6) are required to be engaged "substantially" in commercial banking activity, but members of the securities bar have been comfortable opining that a 20% activity level is sufficient to qualify as "substantial."[32] Unless 3(a)(6) is brought within the scope of the Volcker Rule, a banking entity could conduct proprietary trading activities through the acquisition of a foreign bank subsidiary that is engaging 79.99% in investing, reinvesting, or trading in securities.

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[30] *See generally, U.S. v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 713-19 (1975).
[31] *See* Federated Capital Mgmt. Assoc., SEC No-Action Letter (Aug. 1, 1975).
[32] Seward & Kissel, SEC No-Action Letter (Oct. 15, 2005), *available at* http://www.sec.gov/divisions/investment/noaction/seward101205.htm (last visited Jan. 29, 2012).

## C. Definition of Trading Account

### 1. Exclusion of Repurchase and Reverse Repurchase Agreements

The Agencies must **remove § _.3(b)(2)(iii)(A) from the Final Rule**. The exclusion of repurchase and reverse repurchase agreements ("repos") from the definition of trading account is a violation of the statute. A vanilla repo, while economically a loan, can legally be a sale. The NPR's allowance is so wide as to allow unfettered trading of structured repos as well as vanilla repos. Further, the Supplementary Information's claim that repos are economically loans[33] does not justify the blanket allowance. By convention, a repurchase agreement is booked as a pair of standard purchase and sale transactions. Repurchase agreements are also not treated as loans for the purposes of bankruptcy, regardless of their economic substance.[34] Because repos are not **legally** loans, they would *not* be permitted through the language in Section 13(g)(2) of the BHC Act that allows for the sale of loans. There is no mention of repos in the statute or in the FSOC Study. In fact, there is not a scintilla of support in the Congressional Record for the blanket repo exemption.

The exclusion of repos from the definition of trading account poses a dangerous threat to the financial stability of the United States. Federal Reserve Chairman Ben Bernanke has underscored these risks in an interview with the Financial Crisis Inquiry Commission.[35]

We ask that the Agencies carefully consider the fact that **repos could be used in a variety of ways to evade the rules and serve as a conduit for proprietary trades**. As we will show in detail in *Annexure A*,[36] evasive proprietary trading can be achieved through repos in order to conduct: Shorting, Basis Trades, Put Options, Interest Rate trades, Credit Default Swaps, and Total Return Swaps, among others.

If the Agencies will not remove the exclusion outright, we suggest that they instead reclassify repurchase and reverse repurchase agreements as permitted activities under § _.6, with the following requirements to qualify for the allowance:

- The repurchase or reverse repurchase agreement must adhere to a publicly available, industry-standardized master agreement.
- The stated assets in the repurchase or reverse repurchase agreement must consist only of high-quality liquid assets.

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[33] NPR at 68,862.

[34] *See* Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 Am. Bankr. L.J. 253 (2009) (emphasis added). *citing* Jeanne L. Schroeder. *A Repo Opera: How Criimi Mae Got Repos Backwards*, 76 Am. Bankr. L.J. 565, 567 (2002) (discussing *In re Criimi Mae, Inc.*, 251 B.R. 796 (Bankr. D. Md. 2000)).

[35] *See* Interview by Financial Crisis Inquiry Commission with Ben Bernanke, Chariman of the Federal Reserve at 21 (Nov. 17, 2009), *available at* http://www.scribd.com/doc/48878840/FCIC-Interview-with-Ben-Bernanke-Federal-Reserve.

[36] Please see our detailed answers to Questions 30-32 (*Annexure A*), which outline various legal issues with the NPR's interpretation of the statute, as well as the substantial potential for rule evasion through the use of repurchase and reverse repurchase agreements.

### 2. Exclusion of Securities Lending from the Definition of Trading Account

We suggest that the Agencies **remove** § _.3(b)(2)(iii)(B). If the Agencies will not remove the exclusion outright, we suggest that the Agencies instead reclassify securities borrowing and lending as permitted activities under section § _.6, with the following requirements to qualify for the allowance:

- The assets that the covered banking entity invests in using the proceeds of the securities lending transaction must be restricted to high-quality liquid assets, in order to minimize risk to clients.

### 3. Exclusion of Liquidity Management Programs

As with our suggestions for revisions to the repo and securities lending exclusions, we feel that incorporating an additional requirement into the liquidity management exclusion, that any assets "**consist only of high-quality liquid assets**," will strengthen the Rule and dampen the prospects for future evasion.

## III. PROPRIETARY TRADING

### A. Underwriting

We suspect that the vast majority of comment letters on the proposed implementation of the Volcker Rule will criticize the Agencies for promulgating unduly complicated rules. The proposed implementation of the underwriting exemption is a prime example of the Agencies injecting needless complexity into a simple statutory mandate.

#### 1. The Underwriting Exemption Should be Limited to Registered Securities

The Agencies have transgressed their delegated authority by allowing the underwriting exemption in the Volcker Rule to include private placements. Section 619(d)(1)(B) permits certain "underwriting . . . activities." Not coincidentally, this section is bereft of any mention of "private placement activities" or "placement agent." In issuing implementing regulations, an administrative agency must give effect to the unambiguously expressed intent of Congress.[37] Under the basic securities law definition of the term, an "underwriter" includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security."[38] Such a person is required to file a registration statement before offering to sell a security as part of a primary distribution.[39] Conversely, if a person is legally exempt from the registration statement requirement, that person cannot be an "underwriter" under Section 2(a)(11) of the Securities Act of 1933 ("'33 Act"). For example, a placement agent relying on the Rule 144 exemption is not considered an "underwriter."[40] Thus, the Section 2(a)(11) definition of underwriter would require that any underwriting activities permitted under the Volcker Rule be in connection with regulated securities.

Much to our chagrin, the Agencies have found a way to bypass this basic stricture. In defining the term "underwriter" in the Proposed Rule, the Agencies curiously rely on the definition of that term in Regulation M, instead of the more obvious and basic definition found at Section 2(a)(11) of the '33 Act.[41] Section 2(a)(11) has close to a century of case law and interpretive guidance

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[37] *Chevron U.S.A. Ins. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984).
[38] 15 U.S.C. § 80b-2(a)(11).
[39] 15 U.S.C. §§ 80b-4(1), 5(c).
[40] Preliminary Note to Rule 144. 17 C.F.R. § 230.144 (2012).
[41] *Compare* 17 C.F.R. § 242.100 (2011) (Regulation M definition) ("Underwriter means a person who has agreed with an issuer or selling security holder: (1) to purchase securities for distribution; or (2) to distribute securities for or on behalf of such issuer or selling security holder; or (3) to manage or supervise a distribution of securities for or on behalf of such issuer or selling security holder."). *with* 15 U.S.C.. § 77b(11) (2011) (Section 2(a)(11) definition of underwriter) ("The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security. or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.").

supporting it, and is therefore more appropriate than the Regulation M definition. Further, as noted above, nothing in Section 619 or the Congressional Record suggests that Congress wanted "underwriter" to be defined as per Regulation M. Moreover, Regulation M is not a good definitional source because the underlying purpose behind it conflicts with the underlying purpose behind the Volcker Rule. Regulation M was designed to prevent manipulation and other activities that could artificially influence the market for an offered security.[42] Thus, a broad interpretation of the term "underwriter" was naturally necessary in that context to promote greater investor protection and market stability. However, using the same broad interpretation of "underwriter" in the context of Section 619 would actually undermine investor protection, as it would increase the size of the underwriting loophole through which covered banking entities could conduct risky proprietary trading activities.

The underwriting exemption should also explicitly exclude private placement for a very practical reason: allowing underwriting in private placements would be tantamount to allowing any and all proprietary trading in opaque over-the-counter ("OTC") instruments. OTC markets are generally very illiquid, with few parties willing to buy or sell a particular offering. The Agencies' current interpretation of "customer" is extremely expansive, and includes virtually all counterparties, whether pre-existing customers or not. Thus, any banking entity that purchases a position in an OTC instrument from any counterparty could call itself an "underwriter," under the guise that it intends to later distribute the instrument to other "customers." Even if the banking entity intends to purchase an OTC instrument for purely speculative purposes, it can justify holding that instrument in its inventory under the rationale that no buyers are available because the market is illiquid. This result would render moot the Volcker Rule's restrictions on the riskiest proprietary positions. Instead of conducting safe, traditional, customer-focused underwriting, banking entities would be enabled to continue with their "Originate and Distribute" model, whereby esoteric securities are fashioned from thin air, and "underwritten" solely for fee generation purposes and ***not*** to promote liquidity in non-financial markets.

In light of the above, we recommend the following changes to the Proposed Rule:

> § _.4(a)(2)(ii): The covered financial position is a *registered* security;
>
> § _.4(a)(3): Definition of distribution. For purposes of paragraph (a) of this section, a distribution of securities means an offering of securities~~, whether or not subject to registration under the Securities Act,~~ that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.
>
> § _.4(a)(4): Definition of underwriter. For purposes of paragraph (a) of this section, underwriter means:
>
> (i) A person who has agreed with an issuer of securities or selling security holder:
>
> (A) To purchase *registered* securities for distribution;

[42] FINRA, *Regulation M Filings*, http://www.finra.org/Industry/Compliance/RegulatoryFilings/RegulationM/ (last visited Jan. 5, 2012).

(B) To engage in a distribution of *registered* securities for or on behalf of such issuer or selling security holder; or
(C) To manage a distribution of *registered* securities for or on behalf of such issuer or selling security holder; and
(ii) A person who has an agreement with another person described in paragraph (a)(4)(i) of this section to engage in a distribution of such *registered* securities for or on behalf of the issuer or selling security holder.

**2. Retained or Unsold Allotments are Indicative of Proprietary Trading**

Public offerings are often highly volatile, as an issuer's securities can be subject to drastic drops in price with little or no notice. Thus, an underwriter's retention of a portion of an offering is an inherently risky proposition. A bank's depositors must not be left "holding the bag" for speculative bets on public offerings that turn sour.

A bona fide underwriter's objective is to push the issuer's securities out to market, not to retain those securities for speculation, investment or price manipulation. A banking entity falls short of the objectives behind the Volcker Rule to the extent that it has unsold allotments in its banking book in connection with an underwriting. Underwriters are required to conduct extensive due diligence, so they can reasonably be expected to forecast the demand for a particular offering before actually underwriting it. Consequently, the Agencies can fairly require that a bona fide underwriter have little or no unsold allotments. Accordingly, we recommend that the Agencies add an additional factor to the current seven-part test for underwriting, under which the existence of a "substantial" unsold or retained allotment would be an indication of proprietary trading. The term "substantial" would depend on the circumstances of a particular offering. This factor is similar to § _.4(a)(2)(v), which focuses on near-term demands of customers. However, an "unsold allotment" factor would shift the inquiry from something subjective (demands of customers) to a more objective, quantifiable figure (the number of unsold shares in an issue). Unsold allotments present a conflict of interest vis-à-vis customers. Section 619(d)(1)(B) stipulates that any underwriting activities must be "designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties." Issuers that hire underwriters expect that the underwriter will promote liquidity in the issuer's securities by selling them into the market. Thus, a potential conflict of interest exists whenever a banking entity retains unsold allotments pursuant to an underwriting. Such a conflict would undercut the banking entity's underwriting exemption by operation of the limitation contained in Section 619(d)(2)(A)(i).

Impermissible conflicts of interest can also arise where allotments of underwritten securities are retained for the purpose of "spinning,"[43] instead of being sold in the market. The practice of spinning allows underwriter insiders to profit from IPO price gains, to the detriment of investors and the issuer. The risk of spinning is more pronounced in unregistered offerings, which have less securities law protection. Notably, spinning is only possible where an underwriter does not

[43] Jim Naughton, *The Economic Consequences of IPO Spinning*, Harvard Law School Corp. Gov. Forum, Sep. 30, 2009, http://blogs.law.harvard.edu/corpgov/2009/09/30/the-economic-consequences-of-ipo-spinning/.

sell all of its allotment into the market. Thus, the retention of securities should be viewed by the Agencies with a high degree of scrutiny.

In addition to using the sheer number of unsold securities as an indicator of proprietary trading, the Agencies can also rely on the amount of due diligence documentation compiled by a would-be underwriter. Bona fide underwriting requires extensive due diligence, and so the absence of voluminous diligence documentation would suggest that any unsold allotment is actually a proprietary position. As noted above, under our proposal, the existence of an unsold allotment would not automatically give rise to strict liability, but rather would serve as a factor suggestive of impermissible proprietary trading. However, the combination of a large number of unsold securities and limited diligence documentation should create a very strong presumption of impermissible proprietary trading.

### 3. Equivocal Regulatory Language

Section 619 requires strict compliance with its restrictions on proprietary trading, and not the mere *intention* to comply with those restrictions. The Agencies seemingly lost sight of this fact in drafting the regulatory requirements for permitted underwriting. Sections _.4(a)(vi) and (vii) interpose an element of intentionality into an otherwise strict-liability rule:

> § _.4(a)(vi) The underwriting activities of the covered banking entity are <u>designed</u> to generate revenues <u>primarily</u> from fees, commissions, underwriting spreads or other income not attributable to:
>
> (A) Appreciation in the value of covered financial positions related to such activities; or
>
> (B) The hedging of covered financial positions related to such activities; and
>
> § _.4(a)(vii) The compensation arrangements of persons performing underwriting activities are <u>designed</u> not to reward proprietary risk-taking.

The words "designed" and "primarily" introduce two levels of dilution that threaten to eviscerate the Volcker Rule's restrictions on proprietary trading. A banking entity can easily evade the proprietary trading restrictions by creating facially-complaint policies and procedures that are "designed" to fall within the underwriting exemption, even if they fall short of the exemption in practice. For instance, the Proposed Rule does not forbid a banking entity from benefiting from the appreciation in the value of covered financial positions, so long as the documented "design" of the transaction was to generate revenue from commissions. In fact, a banking entity is even permitted to intentionally design underwriting transactions to generate revenue from price appreciation, provided that those revenues are secondary (i.e., not "primary") to fees earned from commissions. Similarly, a banking entity is free to actually reward its employees for proprietary risk-taking, provided that the compensation arrangements were initially "designed" not to. Simply put, the opportunities for evasion are legion.

Accordingly, we recommend the following revisions:

§ _.4(a)(vi) The underwriting activities of the covered banking entity ~~are designed to~~ generate revenues ~~primarily~~ *solely* from fees, commissions, underwriting spreads or other income not attributable to:

(A) Appreciation in the value of covered financial positions related to such activities; or

(B) The hedging of covered financial positions related to such activities; and

§ _.4(a)(vii) The compensation arrangements of persons performing underwriting activities *do* ~~are designed~~ not ~~to~~ reward proprietary risk-taking.

We recognize that Section 619(d)(1)(B) uses the word "designed" in describing underwriting activities that meet near-term demands of clients. Thus, the usage of the word is appropriate in § _.4(a)(v). However, the usage of that word in other contexts, such as § _.4(a)(vi) and (vii), does not enjoy similar statutory support. Further, such usage actually undermines the general intent of Section 619, which requires strict compliance with proprietary trading restrictions.

### 4. Disgorgement as a Mechanism to Ensure Revenue Generation from Fees

Many of the factors that make up the underwriting definition at § _.4(a) are subjective or easy to evade. The Proposed Rule recognizes that banking entities may not legitimately profit from capital gains earned in connection with underwriting activities, and that compensation should instead derive from fees, commissions or spreads. However, the Agencies have not proposed any practical method to effectively police this restriction.

To ameliorate this practical deficiency, we suggest that the Agencies require automatic disgorgement of any profits arising from appreciation in the value of covered financial positions in connection with underwriting activities, regardless of whether those profits were intended or not. If the Agencies are serious about requiring that fees be based only on commissions and spreads, they should be willing to enforce that requirement through disgorgement. Any profits that banks earn from capital gains could be disgorged to the affected client (e.g., the issuer of the security), distributed pro rata to the bank's depositors, or paid to the U.S. Treasury as a penalty. A simple disgorgement standard would obviate much of the complexity that is inherent to the current implementation of the underwriting exemption. For example, the Agencies would no longer need to distinguish between activities supporting near-term client demand from activity taken for speculative purposes. If a bank were subject to disgorgement, it would no longer have any financial incentive to undertake speculative positions, given that its compensation would be capped at earned commissions. Similarly, the Agencies would not need to concern themselves with winnowing out risk-rewarding compensation arrangements from safe ones. If a banking entity could no longer keep gains from principal risks, it would not create incentives for its employees to take such risks. At most, banks would compensate employees for pursuing underwriting in markets with high spreads (i.e., currently illiquid markets). This result would create strong incentives for increased capitalization in illiquid markets, which should allay some of the concerns that banks have expressed about the Volcker Rule's impact on "liquidity."

Indeed, *we interpret every comment letter lauding the virtues of market "liquidity"*[44] *as a further vindication of an explicit disgorgement requirement.*

**B. Market Making**

Market making is an indispensable component of liquid, efficient markets. This service, however, simply does not belong in banks. One of the most challenging aspects of our attempt to digest and comment on this Proposed Rule has been navigating the presupposition that banks have some inherent role in proper market making. We are familiar with the extensive lobbying efforts by the banking industry to present this idea as a fact, but we propose that the Agencies seriously reconsider this premise for both the safety and soundness of the industry and the simplicity of this Rule. Nobel Prize winner Myron S. Scholes wrote:

> [A] leveraged market-making business is inherently unstable. Banks might be the wrong providers of liquidity to markets. Simply put, leverage can only be reduced by selling assets to raise cash if market makers are making markets in the assets they need to sell and they no longer can continue to do so at times of shock and to make conditions worse, they borrow from each other with short-term financing to hold longer-maturity relatively idiosyncratic assets.[45]

The bank lobbying effort is certainly understandable: market making is a profitable business and one that banking entities certainly do not want to lose. It is well-known that the major dealers have always fiercely guarded their dominance of market making, particularly in the less regulated OTC markets. Firms that attempt to enter this business are regularly strong-armed through anti-competitive arrangements with inter-broker dealers.[46] Again, this is unsurprising: market making desks allow a firm to take proprietary advantage of unparalleled access to valuable customer flow information in the name of "customer service."[47] This is an extremely attractive business. Despite the banks' desire to continue reaping such profits, their contention—that banking entities alone are able and willing to provide this valuable service to the market, and

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[44] *See generally*, Barbara Shecter, *Chorus of Canadians Blast U.S. Volcker Rule*, FP Street, Jan. 5, 2012, http://business.financialpost.com/2012/01/04/canadians-blast-u-s-volker-rule/.

[45] Myron S. Scholes, *Market-Based Mechanisms to Reduce Systemic Risk*, *in The Road Ahead for the Fed* 103, 108 (John D. Ciorciari & John B. Taylor eds., 2009).

[46] *See Intervest v. Bloomberg*, 340 F.3d 144, 2003 U.S. App. LEXIS 16423, at *26 (3d. Cir. 2003) ("According to his ACT Notes, Fondren met again with Matthews and Tom Evans, another Cowen executive, on May 29, 1997. Fondren recorded that Evans initiated the meeting to inquire whether InterVest might assist Cowen in developing its own bond trading exchange over the internet. Matthews, however, seemed less interested in dealing with InterVest and told Fondren that doing business with InterVest was 'viewed by the street as "unhealthy."' When Fondren responded by charging that locking InterVest out of the bond market was anti-competitive and could lead to a lawsuit, Matthews allegedly laughed and said that even if Cowen was forced to pay $10 or $20 million, 'it would be just a cost of doing business.'").

[47] 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("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.").

that regulation will cause irreparable damage to the financial system at large—is unfounded and nonsensical.

It is our opinion that this Rule would be universally improved by removing the blanket exemption for market making, as it presents great financial risk (by providing substantial opportunity for evasion) without commensurate economic benefit. We understand, however, that we are bound by the statute and this unfortunate loophole must be tolerated. Our goal then, in crafting this public comment, is to highlight those areas where the implementation of this legislation will be least consistent with its intent, and provide suggestions and guidance that attempt to improve the Final Rule's substance and effectiveness.

### 1. Illiquid and OTC Markets

We have taken much time and care in addressing the various challenges in implementing this Rule in illiquid and opaque markets, and these thoughts are presented below. However, we have concluded that a meaningful interpretation of the intentions of the statute would prohibit all activities in these instruments.

It should require little reminder that risky and illiquid products—including certain bonds, credit default swaps ("CDS") and other complex derivatives—were crucial contributors to the 2008 financial crisis. For this reason, the original legislation sought to expel these functions from federally-backstopped banking entities. We find it disingenuous to suggest that this was not commonly understood by banking entities, regulators, and the public long before this Proposed Rule was drafted. Senator Merkley explicitly addressed the prohibition of market making in credit default swaps and other "high risk instruments"[48] in his remarks to Congress:

> Barring high-risk strategies may be particularly critical when policing market-making-related and hedging activities, as well as trading otherwise permitted under subparagraph (d)(1)(A). In this context, however, it is irrelevant whether or not a firm provides market liquidity: high-risk assets and high-risk trading strategies are never permitted.[49]

We are troubled by the way this very clear explanation has been ignored throughout the Proposed Rule; exemptions including CDS and other, riskier products are plainly unwarranted and, in our opinion, extremely dangerous.

Additionally, it is clear that Congress's intentions were not to include illiquid markets within the market making exemption. Take for example this scenario referred to by Senator Merkley in the Congressional Record:

> Testimony by Goldman Sachs Chairman Lloyd Blankfein and other Goldman executives during a hearing before the Permanent Subcommittee on Investigations

[48] *Id.* at S5898 ("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.").
[49] *Id.*

> 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.[50]

The Senator rejected the implication that a one-sided market (a market with only a bid or an ask) is a legitimate one, with respect to market making: "one-sided marketing or selling securities is not equivalent to providing a two-sided market for clients buying and selling securities."[51] This speaks both to bespoke structured products, for which markets are "made" by creating and marketing non-standardized derivatives to clients, as well as standardized instruments that trade infrequently and lack consistent market support. The nature of all illiquid markets is that they exist primarily as one-sided markets at any point in time. OTC markets operate with no requirement that a market maker provides realistic and tradable prices in these products at all times. Nor are there systems that would allow the Agencies to monitor or confirm such activity. Despite the Senator's clear declaration of the statute's intent, the Supplementary Information of this Proposed Rule explicitly allows for one-sided markets in illiquid products by including them in the indicia of bona fide market making:

> With respect to securities, regularly purchasing covered financial positions from, **or** selling the positions to, clients, customers, or counterparties in the secondary market.[52]

Further, market makers are often willing to provide neither an executable bid nor ask in illiquid securities. This is precisely what makes such a market "illiquid." We feel that it is impossible to reconcile the clear intentions of Congress with the allowance for illiquid and opaque products.

In the most liquid and robust markets, contemporaneous buyers and sellers can theoretically exist such that the underlying "price" is not affected as bid/ask spreads are captured. In practice, such markets charge exceedingly small spreads, since bid/asks often serve as a proxy for liquidity premiums, and the job of intermediation requires little risk. Incidentally, these markets often charge commissions or fees on top of bid/offer spreads, and many trade on organized trading platforms or exchanges where market-making activity can be easily monitored (as in listed equities). Identifying the source of revenues is reasonably straightforward in these markets, and the Proposed Rule has designed robust measures to enact and enforce the prohibition on proprietary trading within them. In general, we are satisfied with the Proposed Rule's effectiveness within liquid markets, and applaud efforts to ensure such broad and meaningful oversight.

In contrast, the riskiest and most troublesome activity occurs in those markets that share very few of the features described above. Illiquid securities and complex OTC derivatives typically trade infrequently and opaquely, outside of organized platforms, and without the convention of fees or commissions. In essence, these products lack all of the necessary qualities to facilitate even the most basic implementation of this Proposed Rule. Regulators will be unable to monitor, verify,

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[50] *Id.* at S5896.
[51] *Id.*
[52] NPR at 68,871 (emphasis added).

or enforce this Rule in any meaningful way with respect to these products, which provide myriad opportunities for large proprietary positions to be justified, disguised, or overlooked.

We propose the inclusion of the following language into § _.4(b)(1):

> (1) Permitted market making–related activities. The prohibition on proprietary trading contained in § _.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with the covered banking entity's market making–related activities, *provided such activities do not include or incorporate:*
>
> *(i) Assets whose changes in values cannot be adequately mitigated by effective hedging;*
> *(ii) New products with rapid growth, including those that do not have a market history;*
> *(iii) Assets or strategies that include significant embedded leverage;*
> *(iv) Assets or strategies that have demonstrated significant historical volatility;*
> *(v) Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and*
> *(vi) Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;*

In particular, we will discuss here the characteristics of illiquid and complex products that most undermine the effectiveness of the Proposed Rule, and suggest amendments and improvements for the Agencies' consideration.

*a. Bid/Ask Spreads*

The allowance for bid/offer revenues in market making is one of the largest opportunities for abuse of the Rule's proprietary trading prohibition. In his discussion of this legislation, Senator Merkley described how market-making revenues should look:

> Generally, the revenues for market making by the covered firms should be made from the fees charged for providing a ready, two-sided market for financial instruments, and not from the changes in prices acquired and sold by the financial institution.[53]

The designation of bid/ask spreads as appropriate market-making revenue is not mentioned, as the generation of such revenue relies exclusively on changes in the market value of the positions or risks held in inventory. "*Revenues primarily from fees, commissions, bid/ask spreads or other similar income*"[54] is functionally identical to "all revenues," to the degree that they can be meaningfully differentiated.[55]

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[53] 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley).
[54] NPR at 68,872 (discussion of the fifth market-making criterion, § _.4(b)(2)(v)).
[55] The inclusion of the word "primarily" serves to further erode this requirement.

The attempt to reconcile these two conflicting ideas is a primary source of complexity throughout this Proposed Rule, and this conflict serves to diminish the Rule's effectiveness in practice. The FSOC Study indeed highlighted this issue[56] in its recommendations, and yet it remains as a cornerstone of the Rule's structure.

We provide a basic example to illustrate some of the important failings in the practical implementation of this revenue requirement:

> *A market maker in an illiquid bond provides regular indicative markets that are 0.25pt wide, which is seen as standard bid/offer size for this bond. In a given day he conducts 10 trades: 5 buys and 5 sells, all of standard equal size. Three of these trades were conducted with clients, and 7 through an inter-dealer broker. Other trades in this bond occur throughout the day away from this market maker. On average, the trader sold the bonds 1pt higher than he bought them.*

When considering the activity of this trader with respect to compliance with the Proposed Rule, the following questions emerge: were these trades considered legitimate market-making activities, or were some trades clearly market-making-related, and others potentially proprietary? Would all profits be considered legitimate capture of bid/offer spread, or would some portion be attributed to spread, with the balance prohibited? Can meaningful data be provided to assist the Agencies in determining the nature of this activity?

We concede that the activity described in this particular example is over-simplified, and (prohibited or not) it would not by itself reasonably warrant a second look. But in practice, this bond could be one of many traded by a market maker. It might in fact be used to offset one or many other positions or even products. It may, as is often the case, be a small piece of a large and complicated proprietary strategy within a trading book. When this scenario is imagined with trades of sufficient size, and is multiplied across a number of different trading books, the risks accumulate rapidly and such activity cannot be reasonably assumed to be benign.

Clearly there are few reasonable solutions to the regulatory problems posed by bid/offer spreads within illiquid markets. As noted above, our primary recommendation would be to honor the statute by removing illiquid and OTC products from the market making exemption. An alternative remedy would be to require the disgorgement of all profits from market-making related activities.[57] This would eliminate the problem of differentiation of revenues, in addition to significantly reducing the incentive to take prohibited proprietary exposures.

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[56] FSOC Study, *supra* note 29, at 24 ("[M]easuring the revenue that is attributable to the bid-ask spread is difficult and not consistently observable especially in illiquid markets.").

[57] We emphasize that customer-services are rarely profit centers, and the necessity of profiting from the customer-service of market-making should not be taken for granted.

*b. Hedging*

The complicated risk profiles of derivative products require a variety of piecemeal trades to hedge each component risk, and each of these hedges presents new exposures that also require hedging. The trading books of such products quickly become a complicated web of inter-dependent trades that are increasingly difficult to adequately unwind. Illiquid products, for which good hedges rarely exist,[58] are mitigated through proxy hedges[59] that are imperfect (indeed sometimes completely unrelated), but available and economical.[60] In other cases, such risks are seen as uneconomical to hedge at all.[61] This issue is addressed in greater detail below.

*c. Warehousing Illiquid Risk*

In explanation of the statutory prohibition of high-risk assets and strategies,[62] Senator Merkley stated:

> With respect to the definition of high-risk assets and high-risk trading strategies, regulators should pay close attention to the characteristics of assets and trading strategies that have contributed to substantial financial loss, bank failures, bankruptcies, or the collapse of financial firms or financial markets in the past, including but not limited to the crisis of 2008 and the financial crisis of 1998. In assessing high-risk assets and high-risk trading strategies, particular attention should be paid to the transparency of the markets, the availability of consistent pricing information, the depth of the markets, and the risk characteristics of the assets and strategies themselves.[63]

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[58] *See* AllianceBernstein's Comment Letter re Prohibitions and Restrictions on Proprietary Trading – File S7-41-11 6 (Nov. 16, 2011). *available at* http://www.federalreserve.gov/SECRS/2011/November/20111129/R-1432/R-1432_111611_88542_412445985793_1.pdf ("Certainly there are segments of fixed income markets and OTC markets where such hedges do not exist or markets where even the best structured hedges fail to protect the hedging party fully. It is impossible to predict what the behavior of even the most highly correlated hedge will be versus the underlying asset being hedged.").

[59] Interview by Financial Crisis Inquiry Commission with David Bushnell, Former Chief Risk Officer for Citigroup 45 (Apr. 1, 2010). *available at* http://ebookbrowse.com/2010-04-01-transcript-of-fcic-staff-interview-with-david-bushnell-citigroup-pdf-d250783037 ("[I]n this secondary trading desk they would take positions in different tranches of CDOs, triple B, single A, double A positions. to facilitate customer liquidity and customer inquiries. If they happened to be holding a position and they wish to hedge its price volatility, they would use another instrument, ABX indices which traded. in an attempt to hedge the price volatility of the position that they had.").

[60] *See* 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley). Senator Merkley alluded to such hedging practices in his description of the events leading to the 2008 financial crisis: "commercial and investment banks drove into increasingly risky, short-term, and sometimes theoretically hedged. proprietary trading." *Id.*

[61] FSOC Study, *supra* note 29, at 20 ("In general. it may be uneconomical to completely hedge all of the risk to which a trading desk is exposed.").

[62] Proposed Rule § _.8(d)(2)(A)(ii) ("No transaction, class of transactions, or activity may be deemed a permitted activity [] if the transaction, class of transactions, or activity [] would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as such terms shall be defined by rule as provided in subsection (b)(2))").

[63] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

There were few greater contributors to the most recent financial crisis than the warehousing of large illiquid positions. The accumulation of assets for which there is no willing buyer or price clarity is a very risky practice. When this happens throughout an industry that relies heavily on very short-term (often overnight) funding, this practice can be systemically disastrous. It is inconsistent with Congressional intent for the Rule to create allowances for businesses that require significant risk-taking as a matter of course; unfortunately, that is the very nature of market making in illiquid products. This issue is a major concern of the FSOC Study, which states that inventory management related to market making "is especially complex in illiquid markets, as a market maker may be required to assume significant market risk between the time that the large order is purchased and sold back into the market."[64]

We are unable to reconcile the allowance for market making in illiquid assets with either the intentions of Congress, the guidance of the FSOC study, or the true intention of the Agencies to prohibit potentially harmful activities within covered banking entities. If legitimate market making activities require, or otherwise cause, a banking entity to assume large illiquid positions (as the industry claims it must),[65] and those positions cause the banking entity to endure significant losses (as they famously and repeatedly have done), this Rule would be considered a failure.

*d. Provision of Meaningful Data*

The implementation of this Rule relies heavily on the idea that prohibited proprietary activity can be identified through thoughtful analysis of quantitative trade data. This concept in itself raises serious concerns, as we will discuss in greater detail later in this document. Regardless, this supposition assumes that reasonably accurate and meaningful data can be collected. But this is often not the case: illiquid and OTC markets simply cannot provide much of the relevant data, either because market conventions deem it inapplicable or because no systems are in place to reliably capture it. For example, customer initiations cannot be monitored in OTC markets, inventory turnover is not meaningful for derivatives, and bid/ask spreads are subjective and unreliable for illiquid products.

Former SEC Chairman Harvey Pill recently stated:

> First, there has to be a universal requirement that anyone that takes money from the public that can have an impact on the economy must provide a continuous flow of significant data.[66]

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[64] FSOC Study, *supra* note 29, at 19.

[65] *See, e.g.*, SIFMA, *The Volcker Rule Restrictions on Proprietary Trading: Implications for the US Corporate Bond Market* 9 (Dec. 2011) (study prepared by Oliver Wyman Group for SIFMA in exchange for compensation). *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=8589936887 ("[T]o serve customers in less liquid asset classes, dealers must hold inventory well in excess of trading volume.") [hereinafter SIFMA & Oliver Wyman].

[66] Interview by PBS Frontline with Harvey Pitt, Former Chair, Securities & Exchange Commission, *available at* http://www.pbs.org/wgbh/pages/frontline/warning/themes/ought.html (last visited February 4, 2012).

Illiquid and OTC products are unable to provide such data, and their place in the trading desks of banking entities must be reconsidered. This rule cannot be effectively enforced in the very markets where it is most necessary: OTC markets where stability and liquidity are most lacking. Any banking entities or sub-entities hoping to make use of this exemption should be required to demonstrate that they meticulously ensure that this requirement is consistently and obviously met. Here, we urge the Agencies to require all market making–related activities to be conducted on a multi-lateral organized electronic trading platform or exchange such that the necessary market factors can be monitored and confirmed. Such necessary factors include:

- Time of trade execution
- Classification of counterparties (client or dealer)
- Demonstrated provision of regular, continuous, and contextual bid and offer prices
- Aggressor Identification (which party was the provider or taker of liquidity)
- Market side (execution down at the bid or up at the offer)

*e. Near-term Demands*

The requirement that market making–related activities not exceed the reasonably expected near-term demands of clients presents serious potential conflicts of interest, in addition to its lack of applicability to illiquid and OTC markets. We have submitted an alternative Market Making Commentary at *Annexure C*, wherein we have removed the language of this requirement.

The definition of good and useful market making does not depend on the nature of the market being made. If any instrument or market cannot meet the requirements of this Rule, changes should be required within that market in an attempt to conform, otherwise it should be considered prohibited activity.

**2. Illiquid and OTC Markets**

It is clear that much of this Proposed Rule has been based on the assumption that the relevant activity will occur within highly liquid and exchange-traded equity markets. Although this is an excellent simplifying factor, it is tremendously unrealistic. The Commentary in Appendix B delineates how this assumption tends to account for only the most liquid and transparent markets (i.e., listed equities, U.S. Treasuries), and fails to accurately describe market making in most illiquid or OTC markets. We find this particularly troubling, given that this benchmark asset type was not considered to be a contributor to the most recent crisis and is not expected to present significant opportunities to evade the Volcker Rule. **Illiquid markets were and continue to be havens of risky and irresponsible activity, yet they are largely forgiven throughout this Rule.**

We have submitted an alternative Market Making Commentary, attached as an *Annexure C* to this comment letter. Our major concern in providing alternative language was to address the excessive flexibility in the current Commentary's interpretation of illiquid products. We have emphasized throughout this comment letter that the potential for proprietary trading in illiquid markets is massive. An unfortunate consequence of the generalized language in this

Commentary and throughout the Proposed Rule may be the shift of risky practices out of liquid and transparent markets into the less regulated illiquid and OTC products. We have provided alternative language with more stringent requirements for illiquid and complex products, such that they are held to the standards outlined in this Rule more closely.

We outline below the specific issues that we attempted to address in our alternative Commentary.

*a. Removal of Bid/Ask spreads as Legitimate Trading Revenue*

Revenue generated by capturing bid/ask spreads is functionally identical to gains from price movements in the underlying securities. We reject the notion that this is either indicative of bona fide market making or practically feasible to implement, and have removed this from the list of indicia.

*b. Revenue per Unit of Risk Taken, Consistent Profitability, and Earnings Volatility*

This is an extremely important and necessary factor that will provide invaluable information about the nature of the trading activity. We have seen a tremendous amount of concern by banking entities and their lobbyists regarding this particular point.[67] Their concern serves to illustrate the strength of these factors in identifying prohibited activity. We would like to emphasize that trading books with sufficiently low risk and consistent customer-servicing activity will be able to adequately demonstrate the qualities listed above.

*c. Reasonably Expected Near-term Customer Demands*

We reject the notion that an estimation of the "near-term demands of clients" is a meaningful consideration in illiquid markets. The question of "if" there will be demand (near-term or otherwise) is of much greater importance than the degree of such demand, should it exist at all. Regardless of whether such demand is resulting from or in anticipation of client activity, the Rule serves to allow banking entities to warehouse significant illiquid risk for extended periods of time *because* that is just how illiquid markets work. We see this as a grievous logical error that should be stricken from the Commentary and seriously reconsidered by the Agencies in general. This issue will be discussed in greater detail below.

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[67] *See, e.g.*, SIFMA & Oliver Wyman, *supra* note 65, at 10 ("Many elements of the compliance regime in the Proposed Rule seem to be based on an assumption that market making functions should show consistent revenue, risk taking, and trading patterns, both over short time periods (day to day) and across different periods of market conditions. In both more and less liquid markets, customer flows are often 'lumpy' (e.g., via facilitating block trades), and volatile risk-taking and revenue are natural consequences for market makers. In addition, market conditions–and the way market makers both serve customer needs and manage their own risks–can shift substantially over time.").

### 3. Anticipation of Near-Term Client Demands

Liquid exchange-traded products often make use of metrics of market transparency to provide market makers with useful information about market depth, which in turn allows them to form reasonable expectations about their customers' near-term demands.[68] All other markets (namely OTC and illiquid) lack the fundamental structure that allows for such insights. In practice, such near-term demand is most often estimated by vague intuitions like: "The market is going up, so my clients will probably want to be buyers," or, more troublingly, "I want to buy here, so my clients will likely want to buy as well," or unlawfully, "I have non-public information that indicates that my clients will be buyers." This concern was raised in the Supplementary Information for this Proposed Rule,[69] but the Rule fails to address this concern by requiring that the other sources of such information be demonstrable and verifiable by regulators.

Specifically, a market maker could justify the accumulation of prohibited proprietary exposures by claiming that they are driven by his unique understanding of his client base and their expected activity. Such a claim would be practically impossible to confirm, particularly in less liquid or standardized markets. Even more alarming is the functional similarity between such activity and the common understanding of front running.

Conventional market makers have always walked a very thin line between legitimate client intermediation and illegal front running. As market makers contemporaneously execute customer orders and proprietary strategies, it is often difficult to meaningfully differentiate between true trading profits and potentially ill-gotten gains. In general, it is our expectation that the reduced capacity for market makers to take proprietary positions as a result of this Rule will move to significantly re-align the interests of banking entities and their customers.

This effect, however, will be seriously undermined by what we see as a significant logical error in the structure of the market making exemption in this Proposed Rule. Namely, the classification of "near-term customer demand" in the Supplementary Information serves to *require* a market maker to effectively front run his customers in order to qualify for the exemption. We take the following legal definition of front running:

> Frontrunner[s] use their access to material nonpublic market information to take unfair advantage of other market participants.[70]

The Proposed Rule makes it very clear that a banking entity may *not* accumulate inventory in advance of customer trades, unless such accumulation is based on specific information about the near-term demands of their client base. Presumably, such specific future flow information would

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[68] For instance, such information can include Level 2 market data or NASDAQ's Depth of Book data.

[69] NPR at 68,871 (discussion of the third market-making criterion, § _.4(b)(2)(iii)) ("In order for a banking entity's expectations regarding near-term customer demand to be considered reasonable, such expectations should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects.").

[70] U.S. General Accounting Office, *Securities and Futures Markets: Efforts to Detect Intermarket Frontrunning*, GAO/B-245321 (Washington, D.C.: Sep. 26, 1991), *available at* http://archive.gao.gov/d18t9/145088.pdf.

be considered "nonpublic." Further, banking entities may *not* base such anticipatory accumulation on what would be public information, such as general market expectations of price appreciation. We see in the NPR's discussion of § _.4(b)(2)(iii):

> In order for a banking entity's expectations regarding near-term customer demand to be considered reasonable, such expectations should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects. Rather, a banking entity's expectation should generally 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.*[71]

It is difficult to imagine a situation then, where a banking entity would be accumulating demand based on legitimate public information that is "related to clear, demonstrable trading interest of clients, customers, or counterparties,"[72] as such information is indeed rarely made public.

We see the clear potential for conflict and confusion with respect to this Rule, and suspect that market makers may begin engaging in increasingly conflicted activities under the protection of this Rule. We see the demand anticipation criterion as not only unnecessary to the description of bona fide market making, but also a potential source of great divergence in the interests of market makers and their clients. This potentially harmful conflict of interest was highlighted in the FSOC study,[73] and we urge the Agencies to reconsider the appropriateness of this requirement in light of the coinciding statutory prohibition of such a conflict.[74] Anticipatory accumulation of inventory should be removed from the description of market making, and considered to be prohibited proprietary behavior.

Generally, we conclude that the assumption underlying the Supplementary Information's description of this allowance is that market makers are engaged in substantive and trusting relationships with their client base. This situation is idealized, extremely rare, and highly unreliable. In practice, this level of trust can (and often does) translate into an "Order Basis" relationship, meaning the market maker is given the exclusive direction to execute at a given price on behalf of a client. Clearly, such agency activity would not require the significant accumulation of inventory to meet future demand. We would like the Agencies to consider the

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[71] NPR at 68,871 (emphasis added).

[72] *Id.* (discussion of the second market making criterion. § _.4(b)(2)(ii)) ("bona fide market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.")

[73] FSOC Study, *supra* note 29, at 48 ("Proprietary trading presents potentially serious conflicts of interest between a firm's activities that take a directional view and the customer-serving activities that should facilitate proper functioning of markets. A customer could unknowingly suffer financial injury if, for example, the firm were to trade ahead of customer orders or anticipated orders for financial instruments and profit from changes in the market price resulting from the customer's order. Or the firm could trade based on information about a future underwriting deal for the customer, or knowledge of a customer's portfolio of securities.").

[74] 12 U.S.C. § 1851(d)(2)(A)(i).

value of risk-taking market makers in the following context: those market makers that can accurately and reliably estimate near-term customer demand could potentially perform their function nearly as well on an agency basis. Consequently, those who cannot do so should not meet the requirements of the market making exemption.

### 4. Riskless Principal Transactions

As it is currently written, the permitted riskless principal transaction exemption appears to share more qualities with an option than a back-to-back pass through. In a truly "riskless" transaction, there exist no opportunities for the banking entity to influence the transaction's value. We propose specific language to be added to the Rule such that the time and price of any relevant trade is known and agreed upon by both parties. When timing and price need not coincide on both legs of a riskless principal transaction, optionality emerges, which can only be disadvantageous to the client.

We suggest the following alternative definition of riskless principal transaction:

> The covered banking entity is acting as riskless principal in a transaction in which the covered banking entity, after receiving an order to purchase (or sell) a covered financial position from a customer, purchases (or sells) the covered financial position for its own account, to offset a ~~contemporaneous~~ *simultaneous* sale to (or purchase from) the customer, *where the purchase price and offsetting sale price are identical, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee*;

It is clear that any deviation from this structure implicitly includes an element of proprietary trading, and explicitly incentivizes speculative activity. This particular wording would ensure that, when acting as a riskless principal, a banking entity is in fact passing on all gains to the client and is constrained to benefit in no other way.

### 5. Client, Customer, Counterparty

The need to identify and quantify which trades are in fact customer servicing and "customer-initiated"[75] is central to the implementation of this Rule. This can only be sensibly accomplished with a clear and specific definition of customer.

Relationships that are "indirect" should never be considered legitimate customer relationships. The inclusion of "indirect" customer relationships would dilute the Rule and render it ineffective. The inclusion of indirect relationships would define a banking entity's customer base to include all direct customers, customers of their direct customers, and all iterative extensions of such. The explicit differentiation between Direct and Indirect, as well as the explicit exclusion of Indirect from the definition of customer, is essential.

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[75] FSOC Study, *supra* note 29, at 3.

We urge the Agencies to consider that banking entities will undoubtedly seek to benefit from broadening their "customer" base, through which they will be able to make use of the applicable exemptions within this Rule. When considered in combination with the absence of "bright-line" prohibitions of risky activities, this Rule may incentivize improper solicitation of customers by banking entities.

Finally, the FSOC specifically calls for the Proposed Rule to explicitly define the characteristics of a client, and these factors (direct vs. indirect relationships, nature of initiation) should be considered central to such a definition. We propose the following definition of "customer, client, or counterparty" to be used through out the Proposed Rule:

> *A customer is a counterparty that is NOT itself a covered banking entity, and with which a banking entity has a direct and substantive relationship, which was initiated by the client prior to the transaction.*

For the purposes of the Market Making exemption, "client" and "counterparty" should be removed from the language of the Rule, and it is critical to the effective implementation of the Rule that the term "customer" be well-defined.

### 6. Compensation Incentives

Thoughtful and responsible compensation regimes will undoubtedly be one of the most important tools for effecting immediate and substantive improvements to the banking industry, and it follows that this requirement will present the greatest incentives to evade. We are pleased with the prominence of such compensation incentives within the structure of the Proposed Rule, but we have serious concerns with the degree of freedom that the Agencies allow banking entities in designing such regimes. It is unclear that the Agencies could collect sufficiently accurate or indicative data to reasonably measure the degree to which this requirement is met. We urge the addition of a clear explanation of how such a compensation design must be structured, with specific requirements to ensure the practicality of quality enforcement.

All compensation incentives must be, at the very least, based on a metric that meaningfully and responsibly accounts for the risk underlying profitability. Rewarding pure Profit and Loss ("P&L"), without consideration for the risk that was assumed to capture it, is a specific and identifiable characteristic of an arrangement that incentivizes proprietary risk taking. Conversely, incentives that are clearly based on customer satisfaction and prudent risk management will generally be consistent with, and serve to promote, the intentions of the statute.

One method to effectively "weight" revenue with respect to risk could be setting a maximum compensation when the trader's VaR is 0, with a sliding scale that decreases pay as VaR increases. The customer service component is measurable in many ways, including taking qualitative surveys of clientele in a manner similar to the exhaustive surveys by independent consultants that are commissioned regularly by banking entities. Presumably, in the absence of prospective proprietary trading profits, banking entities will be re-evaluating their business

structure to ensure that market making is in fact a valuable customer service, and should develop systems to quantify and monitor the real value of each trader in this context.

It is important to emphasize that the skillset required in a successful risk-taker differs from that required in a successful customer servicer. It is true that a shift in incentives will likely discourage skilled proprietary risk-takers from pursuing careers as market makers. The same shift, however, will encourage skilled customer servicers to join a field that has been long dominated by proprietary speculators. The suggestion that "talent" will flee banking entities as a result of this legislation is clearly not a sensible one.

The Supplementary Information and Appendix B Commentary serve to significantly water down the sentiment of the compensation requirement. For example, the Supplementary Information weakens the Rule[76] by adding the word "primarily,"[77] and should be substantially re-written. The Commentary in Appendix B explains that some consideration of profitable hedging activities should be acceptable, which implicitly provides for inappropriate incentives.

For example, consider two market makers that trade similar products with a similar client base. At the end of a year, both traders have traded comparable volumes, received comparable ratings from their customers, and both have negligible VaRs at year-end. If trader A has made $1mm profit, and trader B is flat at the end of the year, it may be reasonable to conclude that trader A has captured this profit by conducting superior risk-management activities throughout the year. Viewed another way, any significant gains should be seen as equivalent to potentially significant losses in a less agreeable environment, given that proper hedging will always limit both gains and losses of an underlying position. It could be determined that Trader A conducted a hedging strategy that exposed him to sufficient risk to enable $1mm profit (or loss). The circumstances of such a simplified comparison will rarely exist in practice, and clear performance benchmarks will be difficult to establish. There is much wiggle room in this consideration, and we see great risk and little reward to explicitly allowing for it in the Commentary in Appendix B.

In consideration of technical issues, there is an inconsistency between the Rule Text and the Supplementary Information with respect to explanatory facts and circumstances. A footnote[78] in the Supplementary Information states the obvious fact that such facts and circumstances could not reasonably exist to explain compensation incentives that are inconsistent with the Proposed Rule. Acknowledgement of this fact should be made explicit in the Rule Text itself, which currently allows for explanatory facts and circumstances regarding all of the market making criteria, including compensation incentives. We have proposed significant improvements to the language of the Commentary in Appendix B, which we have submitted as *Annexure C* to this letter.

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[76] Proposed Rule § _.4(b)(2)(vii) ("The compensation arrangements of persons performing the market making-related activities are designed not to reward proprietary risk-taking.").

[77] NPR at 68,872 (discussion of the sixth market-making criterion, § _.4(b)(2)(vi)) ("[A] banking entity relying on the market-making exemption ***should*** provide compensation incentives that ***primarily*** reward customer revenues and effective customer service, not proprietary risk-taking.") (emphasis added).

[78] *Id.* at 68,891 n.201 ( "The proposed commentary does not contemplate explanatory facts and circumstances for the compensation incentives factor, given that the choice of compensation incentives provided to trading personnel is under the full control of the banking entity.").

### 7. Numerical Thresholds

In general, we believe that numerical thresholds will be useful to the Agencies in guiding their own operational techniques for monitoring compliance. We encourage the Agencies to develop such thresholds and keep detailed records on the frequency and degree to which they are exceeded. A regular pattern of excessive breaching of such limits should be treated with penalties and increased scrutiny of all trading activities.

We would caution, however, against incorporating such thresholds directly into the language of the Rule for several reasons.

First, we see explicit targets and numerical boundaries as easily abused and evaded by banking entities. In light of the many creative structures that banks use to evade accounting and tax rules,[79] our collective experience overwhelmingly confirms that risk managers at banking entities are indeed uniquely capable of massaging data such that it avoids triggering increased oversight. In light of the extensive explanation of prohibited vs. permitted activity throughout the balance of the Proposed Rule, it is clear that banking entities have sufficient guidelines to determine the permissibility of future activities. The thresholds used by the Agencies to prompt additional investigation should be known by the Agencies alone.

Furthermore, due to the constantly evolving nature of financial markets, having hard-coded numerical thresholds in the Final Rule would provide extensive complication in the future as these thresholds would need to be constantly revised and updated. We see significant risk and limited advantage to including hard numerical values within the Rule.

### 8. Compliance Requirements

A comprehensive compliance regime is certainly the cornerstone of effective corporate governance, and we are pleased with the priority that this was given throughout the Proposed Rule. We do, however, find that the programmatic requirements in this Proposed Rule have some serious shortcomings, and we would strongly caution against placing undue reliance on this facet.

It is worth emphasizing that all major banking entities have had extensive compliance regimes in place for many years, and yet they did not prevent the various systematic failures that occurred in the 2008 financial crisis. In our experience, as a group that includes current and former compliance officers, risk managers, IT professionals, and traders, the general attitude toward compliance throughout the industry is one of contempt. **Compliance requirements are viewed as a nuisance, and compliance officers are frequently ignored.** This attitude yields evasion of rules, incomplete or inaccurate data, and manipulation of programmatic weaknesses. That being said, we do not mean to diminish the dire necessity of robust compliance policies and procedures throughout banking entities. At the very least, we hope to discourage over-reliance on, and unrealistic expectations for compliance regimes within a regulatory framework. At best, we

[79] Joseph Cotterill, *Repo 105: the Fun Starts all Over Again*, FT Alphaville, Mar. 29, 2011, http://ftalphaville.ft.com/blog/2010/03/29/190356/repo-105-the-fun-starts-all-over-again/.

hope to highlight the need for a cultural overhaul within banking entities such that these kinds of policies and procedures are met with due attention and respect. We hope that the Agencies make this a priority, to the extent that they are able to do so.

A straightforward way to improve the efficacy of compliance regimes is to enact a re-focusing of compensation incentives within compliance organizations of covered banking entities. A two tiered approach could 1) bring the general level of compensation of compliance professionals to be more in line with those in the front office, to more accurately demonstrate the importance of these roles to the quality of the banking entity itself, and 2) require a compensation design which explicitly rewards quality practices and their implementation.[80] Similarly, banking entities would be served by applying the same structural changes to other important operational groups such as Product Control, Operational Risk Management, and Information Technology.

### C. Risk-Mitigating Hedging

Our general interpretation of the Risk-Mitigating Hedging exemption is that all proprietary trades can be effectively designated as the hedge of some specific risk to evade prohibition. In an attempt to account for the substantial differences among traded instruments, the Rule has broadened the scope of permissible hedging activity to ubiquity. We will address our specific concerns with respect to the Risk-mitigating Hedging exemption below.

#### 1. Hedged Risks

The Proposed Rule requires a tremendous amount of additional clarity with respect to reasonable, regulated hedging policies.

The Rule text in § _.5(b)(2)(ii) requires that a transaction:

> [h]edge[] or otherwise mitigate[] 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;

The inclusion of "basis risk" raises several serious concerns. First, there is no definition of basis risk in the Proposed Rule. This is a serious omission, given that basis risk is generally understood as the risk that two assets move inconsistently with each other. Basically, a basis risk exists between any two assets at all times, and should not be considered an appropriate type of hedge under this exemption, absent extensive further clarification.

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[80] Programs such as the SEC's Whistleblower program are a relevant incentivization program that may be used as a reference for such reforms. Sec. & Exch. Comm'n, *Dodd-Frank Act Rulemarking: Whistleblower Program*, http://www.sec.gov/spotlight/dodd-frank/whistleblower.shtml (last visited February 4, 2012).

In its explanation of § _.5(b)(2)(iv), the Supplementary Information indicates that basis risk is intended to reference the imperfection of a hedge, and implies that basis risk (like counterparty risk) is an exposure that need not be exhaustively mitigated in market-making operations:

> However, the proposal also recognizes that any hedging transaction will inevitably give rise to certain types of new risk, such as counterparty credit risk or **basis risk reflecting the differences between the hedge position and the related position**; the proposed criterion only prohibits the introduction of additional significant exposures through the hedging transaction.[81]

We see enormous potential for evasion of this Rule by designating any proprietary exposure as a "basis risk," thereby subjecting the exposure to the hedging exemption. For instance, it seems that a banking entity could simply take a proprietary position by hedging half of an offsetting market-making exposure, and designating the other half as a "basis risk" to the degree that the hedge does not fully mitigate the underlying trade.

Furthermore, proper and diligent hedging of derivatives will generally involve one primary hedging transaction, followed by exclusively-basis hedges as secondary exposures require dynamic hedging. Therefore, it is expected that "basis risk" hedging will comprise the majority of all hedging-related activities in many products, and a robust and specific definition and explanation of this risk is essential.

### 2. Hedge Correlation and Appropriateness

It would be disingenuous to presume that there is not broad agreement by traders about which products are appropriately correlated hedges for their own books. Those assets that are appropriate hedges for any given transaction are widely known and accepted throughout its market; they comprise a limited universe. *There should exist a central database that catalogues the hedges that are consistently appropriate for each product.* This will eliminate confusion about what is considered to be "reasonably correlated" for the purposes of this exemption. The only indication of what is intended as "reasonable" comes from the Supplementary Information of the Proposed Rule:

> A transaction that is only tangentially related to the risks that it purportedly mitigates would appear to be indicative of prohibited proprietary trading.[82]

We understand this to mean that the Agencies define "reasonable" as somewhere between tangentially related and perfectly offsetting. This is an unworkably broad definition. It is, of course, not uncommon for correlation to exist among a variety of semi-related financial instruments. Increasingly, banks are developing sophisticated hedging algorithms to determine the cheapest hedge that satisfies correlation inputs, leading to decreased reliance on common-

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[81] NPR at 68,876 (discussion of § _.5(b)(2)(iv)).
[82] *Id.* (discussion of § _.5(b)(2)(iii)).

sense oversight.[83] The degree of correlation, horizon over which the correlation exists, and circumstances causing the correlation to exist are important considerations that are undermined by the inclusion of the word "reasonably."

We would like to urge the Agencies to exercise caution in their assessment of the appropriateness of certain hedges. Many products can be manipulated such that they artificially assume a reasonable correlation that is based on purely technical, rather than fundamental factors. A common practice in illiquid markets, for instance, is for traders to adopt some unrelated but comparatively cheap asset as a "hedge" for their products. With enough sponsorship, such a proxy hedge can abandon its own fundamentals and adopt the technical qualities of the asset that it is meant to hedge. In times of stress, this artificial correlation can break down quickly and turn a hedged position into two naked exposures. This is a dangerous but common practice that should not be permitted within this Rule's hedging exemption, but will require thorough supervision to prevent. A hedge reduces exposure, or else it is not, by definition, a hedge. This point is of great concern to us.

Good hedges will always be able to meet strict requirements, and the Agencies should insist that they will not allow for inappropriate flexibility in this exemption. The current hedging requirement will lead to extremely complicated risk profiles as banking entities increasingly rely on the cheapest satisfactory hedge, and go on to further hedge the extraneous exposures that result from such imperfect hedging. This kind of forward-looking oversight encourages responsibility and combats attempted evasion.

### 3. Hedging Documentation Requirement

The documentation requirement in the Rule applies only to hedges established by managers, not the specific market makers that also intend to rely heavily on the risk-mitigating hedging exemption. Any applicable documentation can be easily and quickly produced by traders, if they are in fact conducting a trade with a specific hedge in mind, as is required. The implication, then, is that market makers need only provide a post-hoc explanation for a trade's reliance on this exemption, which (given the enormous scope of related risks allowed in the Rule) will be easy to abuse. We urge the Agencies to remove all references to "levels of organization" in the language of § _.5(b), as the necessity for compliance is irrespective of seniority. Additional documentation should be required of all trades that intend to rely on the risk-mitigating hedging exemption. The process for confirmation and substantiation of trades utilizing this exemption should be streamlined and accessible for regulators to monitor.

As a group that includes former traders, we feel that it is important to emphasize that traders are typically intimately aware of their risk profiles at all times, and the impact of trades they

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[83] *See* Izabella Kaminska. *Rise of the Central Execution Desk*, FT Alphaville. Oct. 4, 2011, http://ftalphaville.ft.com/blog/2011/10/04/692511/rise-of-the-central-execution-desk/ ("Since no bank is naturally privy to perfectly balanced flows, it's increasingly becoming the role of quant teams to identify cheaper hedging alternatives which happen to work just as well as hedging with like-for-likes. This applies to both banks' internal 'matching' strategies as well as to what instruments they use for hedging their net positions in the wider market. It's also one reason cross-asset trading has also become so popular.").

conduct. If a trader does not have time to jot down a few known details of a given trade, the Agencies can be assured that he has not thought through the impacts of the trade, which consequently cannot be considered a legitimate risk-mitigating hedge.

Here we will propose an example of responsible documentation requirements:

Each trade should explicitly note which specific risk it is intended to hedge. If it is an exactly-offsetting trade (i.e., a bond sale to hedge a previous purchase of the same bond), the trader must write down the approximate current risks in that asset (e.g., Duration, Treasuries, etc.), and the approximate offset that will be caused by the given hedge. These running-total approximations, then, should match the asset's official intraday risk at all times, which can be easily confirmed by regulators. If it is an imperfectly offsetting trade (i.e., a bond sale to hedge a previous CDS sale), the trader must write down the approximate current risks in **both** assets (DV01, IR risk, bond risks, etc.), the approximate offset that the trade will provide in the applicable risk type(s), **and** the new risks caused by the imperfect hedge (e.g., basis risk, treasury risk, etc.).

It will undoubtedly be argued that this is an impossible requirement for traders to document with each trade, due to the fast-moving nature of their business. This is patently untrue. Traders have always, of course, found time to record the execution details of every trade at the time of execution, and the requirements above will add only a few more keystrokes to an already streamlined process. All competent traders necessarily have the relevant approximations in mind for every trade all day long, and any trader who claims that such requirements take too much time should be seriously examined for competency in his product. This set of requirements is a simple and meaningful way to ensure that all trades indeed have a permitted and deliberate intention at the time of execution, and provides regulators and managers with a real-time, intuitive way to monitor compliance. Automation and increased reliance on electronic platforms will also serve to ease time requirements and increase accuracy of such data. This type of requirement has the added benefit of encouraging traders to focus on maintaining an accurate and responsible understanding of their risks as such risks evolve throughout the day. Extensive additional documentation requirements are necessary to achieve compliance with the Proposed Rule. The "burden" of quickly committing known information to paper or database is both negligible and essential for the proper implementation of the Rule.

### 4. Portfolio Hedging

We are alarmed by the focus on "portfolio hedging" throughout the risk-mitigating hedging exemption. We interpret the intent of this exemption as relating to Delta One or central execution desks that have become ubiquitous across banking entities in recent years. Certainly these central hedging operations pose significant risks, as famously exemplified in the rogue trading scandal that caused a $2.3 billion loss in 2011.[84] While it is clear that such practices necessitate increased oversight and significantly improved risk-management procedures, there are other instances of aggregated hedging that will be inappropriately included within "portfolio hedging" that require consideration. Even outside of central execution desks, many risks are

[84] Frank Jordans, *UBS Rogue Trader Losses Reach $2.3 Billion, CEO Not Resigning*, Huffington Post, Sep. 18, 2011, http://www.huffingtonpost.com/2011/09/18/ubs-rogue-trader-losses_n_968491.html.

currently managed on an aggregated basis, due to the numerous, and often compounding, proprietary portfolios that exist on every market making desk of every covered banking entity. With so many independent strategies at play, it is not uncommon for large exposures across a variety of assets to result when they are combined in the view of a manager. Management will often make use of a "back book" or "management book" for the dual purposes of conducting broad-line hedges against lumpy trading-desk exposures, and taking proprietary positions that fall outside of the mandate or risk-limits of an individual trader. While it is expected that such obvious proprietary exposures will diminish with the implementation of this Rule, we fail to understand the continued relevance of most management hedging operations once individual trading books pare their component exposures. We are troubled by the potential for such "back books" to become havens of prohibited proprietary activity after the implementation of this Rule.

A specific requirement that each type of exposure be designated as one that is hedged exclusively on an Individual or an Aggregate basis is essential. Risks should never be hedged on both an individual and aggregate basis, and most risk types are appropriately mitigated in only one of the categories. For instance, counterparty risk should always be (and in practice, typically always is) mitigated on a portfolio basis, and individual traders should not be able to make use of the hedging exemption by claiming mitigation of such a risk. These risks can be managed by a level of organization that is out of touch with the day-to-day operations of a trading desk. We propose that the Agencies consider requiring banking entities to create central "Risk Management" groups to perform aggregated hedges, to the extent that such groups are not already in place.

The broad allowance for aggregated hedging is troubling and its exemption is inconsistent with the intentions of this Rule. This rule mandates strict risk mitigation at a micro level, and should remove all implicit or explicit allowances for the dangerous practice of management hedging. More generally, a banking entity's need for substantive aggregated hedging is indicative of a failure to appropriately mitigate risks at lower levels within an entity, and is therefore in violation of the spirit of the Rule. We acknowledge that the statute allows for aggregated hedging in Section 619(d)(1)(C),[85] and we hope that the Agencies are prepared to be diligent in monitoring this activity closely to discourage abuses, which we see as a serious risk.

### 5. Anticipatory Hedging

We have several technical concerns arising from the allowance for anticipatory hedging within the Supplementary Information. First, we are alarmed by the potential similarities between anticipatory hedging, as described in the Supplementary Information, and a common understanding of illegal front running. We see a potential for confusion or conflict with respect to such a differentiation. Furthermore, this issue is not addressed in the Statute, the Congressional Record, the FSOC Study, or the Rule itself. Its inclusion within the Supplementary Information is potentially problematic and unsubstantiated by any relevant input,

[85] 12 U.S.C. § 1851(d)(1)(C). *See also* Proposed Rule § _.5(b)(2)(ii) ("Hedges 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.").

and so we propose that this language be completely removed from the Supplementary Information.

### 6. Suggestions

In summary, we recommend the following suggestions with respect to the risk-mitigating hedging exemption:

- Require that all risks be hedged. If the responsible mitigation of a risk is considered "uneconomical," it should be considered a prohibited proprietary exposure.
- Require that each type of exposure be designated as one that is hedged exclusively on either an Individual or an Aggregate basis.
- Prohibit market making in assets with complicated risk profiles (e.g., OTC derivatives, Fixed Income, other illiquid positions, etc.).
- Explicitly limit the universe of acceptable hedges to those that are universally understood to be appropriate for a given product, to promote consistency across banking entities.
- Remove any explicit or implicit allowance for anticipatory hedging.

## D. Permitted Trading Outside of the United States

### 1. Criteria for Permitted Trading Outside the United States

The foreign trading exemption outlined in § _.6(d) is clear and effectively delineated. The criteria required to qualify for this exemption, § _.6(d)(1)(i) and (iii), are appropriate, effective, and must be retained in the Final Rule. Also, the Final Rule must require that **all** of these criteria be met in order for the exemption to apply.

The criteria of § _.6(d)(1)(i) ensure that U.S.-domiciled banks do not simply ship their proprietary trading offshore, and further guarantee that holdings of U.S. banking entities that are **already** offshore are not allowed to skirt the Volcker Rule. Section _.6(d)(1)(iii) is critical because without it, foreign banks could conduct proprietary trading through their U.S. offices, and enjoy the benefits of being in the U.S. markets without being required to adhere to the rule of law in this country.

The remaining definitions in this exemption—the definition of when "purchase or sale occurs solely outside of the United States," as well as the definition of "resident of the United States"—are sufficiently clear, effective, and necessary to be retained in the Final Rule in order to avoid rule evasion by subversion of this foreign trading exemption.

## E. Appendix A - Quantitative Measurements

We see the uses of reported quantitative measurements as generally comprising three main goals, each of which will be addressed by the data with varying degrees of effectiveness.

i. Indication of Prohibited Proprietary Activity

The quantitative measurements mandated by the Proposed Rule will be least effective in serving to identify or predict potential proprietary trading activity within a banking entity. In general, the required measurements may be able to indicate the most serious abuses of this Rule's intent, but the vast majority of proprietary trading would not become differentiable through any analysis of these data.

ii. Indication of High Risk Exposures of Strategies

This will be a much more useful and indicative purpose of the reported quantitative measurements. While the measurements are only as reliable as their component data, and do little to account for extreme events or "fat tails," they will generally provide a high-level overview of an entity's risk profile such that aberrations may be observed or inferred.

iii General Assessment of Risk Profiles

These quantitative measurements will be **absolutely critical** for the Agencies' ability to monitor and regulate banking entities and their complicated interactions with each other. The quantitative measurements are extremely effective in this capacity.

Taken together, these quantitative measurements serve to provide a general overview of the types of risks and activities conducted at a banking entity, and we again caution the Agencies to maintain realistic expectations about what information these measures can provide. The specified measurements are effective because they are the most indicative standard market metrics available today. There are serious limits to the capabilities of these measurements, and the potential for abuse and manipulation of input data is significant. We urge the Agencies to always take a holistic view of risky activities, and never rely on these measurements as dispositive tools for anything. Despite their various shortcomings, we are strongly in support of the current requirements for quantitative measurements, and do **not** feel that their role should be in any way diminished. Without the reporting of these measurements, we believe there would be significant evasion of the Volcker Rule by the banking entities.

**1. Definitions**

Our major concern lies with the possibility of the Volcker Rule allowing for an inappropriately large trading "unit." The "trading desk" is the most fundamental, universally understood unit in every trading or market making operation. Risk exposure and related compensation are inextricably linked to the trading desk. While risk management also happens at higher levels with several trading desks combining to form a larger category of trading (e.g., Global Credit Derivatives, U.S. Equity Derivatives, etc.), we are concerned that the current definition may allow for inordinately large units. An oversized "trading unit" could combine significantly unrelated trading desks, which would impede detection of proprietary trading activity. A more

effective alternative definition would be to use the criteria listed in footnote 191[86] of the Supplementary Information. Footnote 191 defines the trading unit with sufficient granularity. We are pleased that the NPR has moved to require measurements at multiple levels of organization, which will serve to combat evasion concerns.

With respect to technical matters, we find the reporting frequency is extremely effective and should not be reduced in any way. Additionally, the recordkeeping requirement should be extended to 6 years, such that it matches the NY State Statute of Limitations for Contracts.

### 2. Enhanced Reporting Threshold

In general, we are satisfied with the $5 billion threshold for enhanced reporting requirements, as it a sufficiently small number that the vast majority of problematic operations should fall safely above it. However, with respect to derivatives valuations, we are concerned that large exposures may be poorly accounted for in such regimes. For instance, in the criteria set by Call Report's Schedule RC-D,[87] credit default swaps and other derivatives may be valued substantially lower than their notional exposure. For example, a $100 million credit default swap could have a "fair value" of close to zero on the day of inception. This is the standard risk-weighted evaluation, but the public's collective experience with AIG in recent years demonstrates the significant dangers of large unmonitored derivative positions. Thus, neither the $1 billion nor the $5 billion threshold is meaningful should the banking entity hold a substantial portion of its assets in derivatives, the "fair value" calculation of which may not properly reflect the inherent risk involved.

We propose that all banking entities that engage in any trading operations (regardless of threshold) be required to provide the limited reporting requirements specified in § _.7(a), in addition to:

i. <u>VaR Exceedance</u>

These firms will already be calculating and reporting VaR, so this should be a simple and illustrative addition.

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[86] NPR at 68,885 n.191 ("As noted in Appendix A, the Agencies expect that this would generally be the smallest unit of organization used by the banking entity to structure and control its risk-taking activities and employees, and would include each unit generally understood to be a single 'trading desk.' For example, if a banking entity has one set of employees engaged in market making-related activities in the equities of U.S. non-financial corporations, and another set of employees engaged in market making-related activities in the equities of U.S. financial corporations, the two sets of employees would appear to be part of a single trading unit if both sets of employees structure and control their trading activities together, making and executing highly coordinated decisions about required risk levels, inventory levels, sources of revenue growth and similar features. On the other hand, if the risk decisions and revenue strategies are considered and executed separately by the two sets of employees, with only loose coordination, they would appear to be two distinct trading units. In determining whether a set of employees constitute a single trading unit, important factors would likely include whether compensation is strongly linked to the group's performance, whether risk levels and trading limits are managed and set jointly or separately, and whether trades are booked together or separately.").

[87] Fed. Deposit Ins. Corp., Schedule RC-D – Trading Assets And Liabilities, Reports of Condition and Income Instruction Book, *available at* http://www.fdic.gov/regulations/resources/call/crinst/2011-09/911RC-D_093011.pdf.

ii. Risk Factor Sensitivities

All banking entities that maintain risky portfolios will be already calculating their risk factor sensitivities, and should be able to easily furnish these to the Agencies. This will help the Agencies gather holistic data about the market, its participants, and their relative exposures within it. It should be highlighted that even very small firms can have large notional derivative exposure, due to the current "fair value" accounting treatment that such derivatives receive for purposes of qualifying as trading assets and liabilities.

iii. Risk and Position Limits

Limits-setting/limits-monitoring is a basic requirement for a banking entity's compliance procedures. It should be reported to the regulators to evidence the effective operation of the policies and procedures implemented as part of a bank's compliance program.

### 3. Thoughts on Current Measurements

The proposed quantitative measurements are generally appropriate for certain liquid and transparent trading activities. We have some specific concerns with methodology, and we would like to reiterate that many of the measurements are not meaningful in illiquid markets or for derivatives instruments.

VaR, Stress VaR, and VaR Exceedance

VaR gives a high level indication of the level of risk held by a banking entity at a given time. In theory, generally high levels of risk, or abnormalities in risk profiles, may be indicative of inappropriate warehousing of risk, and therefore of proprietary activity. In general, however, we expect this measure to indicate a general snapshot of risk levels for the purpose of comparison within the industry. We have a number of criticisms of current Value-at-Risk measurements and methodologies, but in general we recognize that this metric is ubiquitous because a superior alternative has not been developed.

In general, we would like to emphasize that VaR calculations are heavily reliant on the quality of input data, and many markets are unable to provide sufficient information such that VaR calculations are meaningful. In particular, illiquid products for which accurate historical price and market information is sparse can severely under-represent true potential losses under VaR calculations. We caution the Agencies to treat all quantitative data with due caution and approach their value with appropriate expectations.

VaR Exceedance may be useful to the regulators as an indicator of the quality of the VaR measure relative to the profit and loss of the trading unit. A more rigorous back-testing process would serve as a better analytical tool to evaluate the quality of the VaR model result and should be included as an additional metric.

The definition of VaR has not been made clear as it is missing some important information regarding methodology. The exact calculation method should be specified by the Agencies, and

standard guidance should be provided as follows:

We recommend the use of **historical Value-at-Risk with a 1-year and 5 -year look back, for which a daily 95 and 99 VaR should be given**. An additional requirement could show regular VaR with exponential down-weighting factors of 0.97 and 0.99 (daily 95 and 99 VaR results given in both cases).

Variability of the VaR model result against a standard benchmark portfolio should be reported to the regulators. We recommend that the Office of Financial Research ("OFR") define a benchmark portfolio and calculate a benchmark VaR against that portfolio. Each bank, as part of its daily reporting, should provide its VaR calculation to the regulators for comparison with the OFR benchmark. The OFR benchmark portfolio should include calculations for each product traded at the banks. Variances between the bank's model and the OFR standard should be explained by the reporting banking entity.

VaR methodologies tend to vary across banking entities, leading to data sets that will be incomparable for the purposes of the Agencies. We propose that a standard calculation methodology be developed by OFR. Similarly, a central repository for historical calculation data for each asset should be created and administered by the OFR for the purposes of standard calculation across the industry.

Risk Factor Sensitivities Risk and Position Limits

Risk Factor Sensitivities will be the most useful tool for identifying the accumulation of market risk in different areas of a banking entity. We are concerned with the examples in the Supplementary Information, and see some serious omissions from the list of examples of risk factor sensitivities for several products. For example, Equity Derivatives lack any reference to the various Greek risks (Delta, Gamma, etc.) inherent in all positions. Credit derivatives lack mention of recovery or default risk. It is **very** important that banking entities understand that they must provide **all** risk data for a given product, as this will be the only way for the Agencies to obtain a holistic picture of the banks' true risk profiles.

Additionally, as it may be possible to disguise risk factor sensitivities at particular calculation times, we suggest several risk factor sensitivity snapshots be taken throughout the day, with an average value reported at the end of the day to Agencies. The Portfolio PnL associated with such sensitivities should always be reported in conjunction with each snapshot.

Comprehensive Profit and Loss, and Portfolio Profit and Loss

If these metrics are responsibly calculated and reported, they should serve as a secondary indication of risk levels taken throughout an entity. We would like to caution the Agencies that these will be the most demonstrable and commonly understood metrics,[88] and therefore such metrics hold the greatest risk of manipulation by individuals within the banking entity.

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[88] *See* NPR at 68,957 (Appendix A) ("*General Calculation Guidance:* Comprehensive Profit and Loss generally should be computed using data on the value of a trading unit's underlying holdings, the prices at which those holdings were bought and sold, and the value of any fees, commissions, sales credits, spreads, dividends, interest income and expense, or other sources of income from trading activities, whether realized or unrealized.").

Additionally, we propose a slight change to the Calculation Guidance for Comprehensive Profit and Loss, which seems to include a small but serious error. "Spreads" is a largely meaningless word with respect to PnL calculations, and should be removed from the list of components of Comprehensive PnL. We would like to note that the description of Comprehensive PnL in Appendix A states that this metric "should generally equal the sum of the trading unit's (i) Portfolio Profit and Loss and (ii) Fee Income," but the word "spreads" is not included in the description of either of those component parts.

Fee Income and Expense

This will be a tremendously useful indication in liquid markets that trade with the convention of fees and commissions. This metric will be less useful, but still indicative, in other markets that use inter-dealer brokers to conduct non-client activities.

Spread Profit and Loss

Spread Profit and Loss is ***not*** effective as defined. Outside of the most liquid and transparent markets, the Calculation Guidance for this measure is largely nonsensical, as the guidance for bid/offer spreads illiquid markets amounts to "just make it up." This may be a useful metric in very liquid markets, but we see the NPR's potential reliance on this particular quantitative measurement within illiquid markets as an indication of a very serious lack of understanding of how such markets behave.

The current definition provides the banks with almost total discretion over these numbers. As a consequence, any firm that has a trading unit with illiquid products for which a bid/ask spread is unobtainable will report aggregated metrics such as VaR and Comprehensive Profit and Loss attribution based on unconfirmable data.

There is currently no requirement to disclose the impact of the contribution of these trading units' positions in the aggregated metrics. That impact must be clearly disclosed for all affected metrics. It should further be documented that including such "guesswork" serves to compromise the integrity of the remaining data.

In our experience, it is very well-known that reliance on such "proxy" instruments for illiquid pricing predominantly yields arbitrary or even outright false information, in all cases serving to provide the greatest mark-to-market benefit to the relevant trader. In any of a variety of products that have zero applicable market data, this "garbage in" is in fact what such proxy regimes are demanding.

If banking entities are permitted to continue trading illiquid products and some attempt to artificially quantify them must be made, we urge the Agencies to understand that the resulting reports will yield very little useful data and should be treated with extreme caution.

Comprehensive Profit and Loss Attribution

This is a good, common sense metric that will serve to provide a general overview of a banking entity's trading and risk activities. However, the mention of "customer spreads, bid-ask spreads"

is extremely unclear in the Guidance. "Customer spreads" is not an understood concept, nor is its intended meaning included anywhere in this Proposed Rule. Further, we are unclear how "bid-ask spreads" would be meaningfully separated from either trade PnL (or P&L resulting from closed-out buy/sell pairs of identical transactions) or mark-to-market gains or losses from new trading positions on the books. We propose the removal of both of these terms from the Calculation Guidance.

Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss
This is a useless measure as currently defined, because the calculation periods are inappropriately short to yield meaningful data. 30 days or even 90 days is insufficient for estimating these statistics, which can be demonstrated by any computational package thus: Take a Student's t-distribution with say 3 degrees of freedom, take a sample size of 30 or 60 or 90, and compute the sample skewness and kurtosis. Do this 10,000 times for each window length and view the histogram of the resulting estimates. It will be observed that there is not a tight band around the "true" value. We strongly suggest using 2 years of daily data as an appropriate calculation period for these measures.

Inventory Aging, and Inventory Turnover
This is a useful metric only with respect to certain cash securities. With derivative securities, Inventory is not a very useful factor for the purposes of this Proposed Rule.

Customer-facing Trade Ratio
This will be an incredibly illuminating metric if the word "customer" is defined in this Rule as we have repeatedly proposed in this comment letter. The failure to differentiate between customers and other non-customer counterparties, however, will render this metric a meaningless one.

Pay-to-Receive Spread Ratio
This will not be a useful metric because it is neither possible to collect useful data on bid/offer spreads for many products, nor are there systems in place to capture or monitor such data.

### 4. Additional Metrics

We propose that the Agencies consider including several additional quantitative measurements that would fill important holes in the current reporting regime.

An important measurement that is missing from this list is a Liquidity "Gap Risk" metric, which estimates the price change that occurs following a sudden disruption in liquidity for a product. There needs to be an industry-wide effort to more accurately measure and account for the significant effect that liquidity, and changes in its prevailing level, have on the valuation of each asset.

We also recommend that VaR back-testing results be added to the list of required metrics. This would provide a more robust measure than the proposed VaR exceedance requirement. These results compare actual profit and loss to VaR estimates and can be used by the regulators to

evaluate the effectiveness of the VaR model for capital calculation purposes. These results should be incorporated into the quantitative measures requirement to help the regulators determine the reliability of the VaR data.

Additionally, entity-wide inflation risk and counterparty risk assessments should be produced on a daily basis.

### 5. Illiquid Assets and Model-Based Valuations

The quantitative measurements do not provide useful information as applied to all asset classes. Less reliance should be placed on the quantitative measures for those asset classes that trade in relatively illiquid markets since the data on which the calculations are based may be unobservable, model driven or stale. Absent a metric to measure the quality of the underlying data, these measures should be subject to greater scrutiny, and the impact of these data should be clearly disclosed.

For trading strategies that rely heavily on models to calculate risk exposures (e.g., correlation trading portfolios, etc.), additional disclosures in the Risk Factor sensitivities should be required to evaluate the reliability of the model-driven reporting.

Similarly, additional disclosure in the Risk Factor Sensitivity reporting should be required to evaluate the quality of the metrics for portfolios that have exposure to Assets having value that is model-derived. This requirement can be linked to the Level 1, 2 or 3 classifications used by the firm to report its positions in its financial statements. For example, if total Risk Factor sensitivities contain exposure from Level 3 (model-derived valuation) assets, an additional disclosure identifying the Risk Factor Sensitivity to those assets should be required.

### 6. Burdens

With respect to the balance of benefits vs. cost, we would hope that if more appropriate or indicative measurement methodologies were to become available, the cost of such would not be a relevant factor. The regulatory value of each piece of data already significantly outweighs the operational cost of calculating and reporting it, and such reporting could conceivably be much more expensive before its incremental value could be reasonably called into question. We urge the Agencies not to attempt to upset this balance, in favor of cost, in any way.

The relevant infrastructure is already in place, and minimal additional resources should be required to implement the reporting of quantitative measures in this Rule. The general Calculation Guidance is consistent with current industry practice for managing risk, preparing profit and loss attribution, and preparing financial reports. We can see a number of potential complications due to the poor design or implementation of current practices (for instance, varying VaR calculation methodologies across business units in a banking entity). The Agencies must be diligent in ensuring they receive the highest quality data from banking entities in light of such challenges.

Following the financial crisis of 2008, it was our collective experience as industry professionals that many banking entities realized that their fragmented risk management systems were a substantial problem that needed to be addressed. In the years following the crisis, substantial efforts were made at banks, both domestic and foreign, to consolidate risk models, build the appropriate software infrastructure, and facilitate oversight by senior management and the risk departments. Efforts like these were undertaken at many banks and these efforts should flow easily into the metrics that the Agencies are requesting for reporting in this Rule. Any claim that such an implementation would be too costly to perform ignores the fact that similar initiatives were launched, planned, and executed in the wake of the 2008 crisis. We acknowledge that even given such efforts, there will still need to be tweaks and adjustments made to account for the reporting demanded by the Volcker Rule. They should not, however, be so substantial as to be burdensome. Indeed, the need for new, independent efforts to build firm-wide risk systems to comply with this Rule should be seen as an indication of serious shortcomings in current risk regimes. Implementing these reporting requirements will only promote the safety and soundness of the banking industry at large.

### F. Burdens and Benefits of the Volcker Rule on Trading Activities

If this Proposed Rule succeeds in redefining the landscape of risk-taking within covered banking entities, it will surely require time and resources from the industry to adapt and accommodate the new structure. Despite the disingenuous claims from affected firms and their lobbyists, it is unclear that this Rule, as written, will markedly alter the current customer-serving business. Indeed, this Rule has gone to excessive lengths to protect the covered banking entities' ability to maintain responsible customer-facing business. At times it has even done so at the expense of clear and firm rulemaking.

The largest and most vocally opposed effect on banking entities will be the reduction in highly profitable proprietary trading within their market making businesses. This is a necessary consequence, and we feel it unworthy of reconciliation in the context of this Rule's intent. Senator Conrad put the costs of implementing this legislation into perspective in his explanation to Congress: "This bill is an insurance policy against an expensive future taxpayer bailout."[89]

It is offensive to suggest that the burden of diminished revenues for banking entities may outweigh the significant improvements to the safety and soundness of the banking industry that will result from proper implementation of this Rule.

Additionally, a costly but necessary reorganization of skillsets within banking entities must take place. Those individuals who are skilled proprietary traders are not necessarily the same as those who are skilled customer-servicers with respect to market making. This complicated reorganization, however, will hopefully be facilitated by the concurrent shift in compensation incentives across banking entities. Skilled proprietary traders will be better paid in hedge funds and other entities where risk-taking is valued and rewarded. Similarly, those with the ability to

[89] 156 Cong. Rec. S5893 (daily ed. July 15, 2010) (statement of Sen. Conrad).

effectively serve customers while minimizing risk will be attracted to the trading desks of covered banking entities, where their skills will now be in demand.

To the extent that current business structures remain intact, we expect that customers will in fact see significant benefits from this approach:

- Their interests will become aligned with those of the banking entity. (i.e., customers will no longer be seeking a "customer service" from a market competitor)
- Assets will be priced according to more realistic market liquidity, supply and demand, and associated risks (i.e., prices will no longer be subsidized by other proprietary profits, and bid/offer spreads will align with actual market depths, etc.)
- The net provision of liquidity by market makers will increase as they continue to provide, but cease to simultaneously "take" liquidity through proprietary activities.

We see the alignment of interests of market makers and their clients as one of the most important effects of the Proposed Rule. The current market structure, wherein proprietary trading market-maker hybrids are presumed to provide an unencumbered "service" to customers, is clearly rife with conflicts of interest. In all markets, market makers are provided with valuable market flow information in exchange for acting as an on-demand counterparty. The understanding is that a good market maker will make use of that information to efficiently manage client flow, such that he can sell what he buys for a nominal profit and re-up his capacity to take on his clients' trades. When a market maker is also acting as a proprietary trader, however, this flow information (i.e., the size and timing of his clients' investments) exists as the basis for his proprietary strategy. What this implies, and certainly what we have experienced in practice, is that **a market maker effectively profits from proprietarily front running his clients**. Clients know this, but banks have long colluded to ensure the continuation of a system with few alternatives for intermediation.

If it is the case that certain businesses prove to be unviable within covered banking entities following implementation of this Rule, a period of adjustment will be uncomfortable but necessary throughout the industry. One obvious aspect of this adaptation will be the emergence of new firms that seek to capture the profitable intermediary business that is exited by banking entities. In consideration of the necessary growing pains associated with such adaptation, it should be noted that many firms are already well-positioned and eager to enter or expand within this business, and such firms should be expected to ease such transition.[90] The customers of banking entities will face the burden of navigating a new pool of service-providers as roles readjust throughout the market. Their relationships with covered banking entities, however, will improve dramatically as conflicts of interest are eliminated and true customer service is prioritized.

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[90] Laura Marcinek & Erik Schatzker, *Lutnick Says Dodd-Frank Law May Be 'Violently Beneficial' for BGC Partners*, Bloomberg, Jan. 11, 2012, *available at* http://www.bloomberg.com/news/2012-01-11/lutnick-says-dodd-frank-may-be-violently-beneficial-for-bgc.html (quoting Howard Lutnick, CEO of inter-dealer broker BGC Partners as saying that "Dodd-Frank will either be beneficial, or violently beneficial for BGC Partners, I'm just not sure which one.").

Additionally, it is our hope that the Proposed Rule's increased compliance and reporting requirements will encourage banking entities to pay greater attention to risk profiles, and promote a more holistic and responsible approach to risk management throughout the industry. Certainly, many jobs will be created as banking entities grow Compliance, Risk Management, and other operational divisions. Regardless of the amount of paperwork it may necessitate, we see this increased diligence as a benefit, not a burden.

It has become common understanding in the years since the onset of the financial crisis that the single most important contributor to ensuring functional liquidity in markets is a healthy and safe banking system. This Proposed Rule, despite all of its shortcomings, will do more to promote the safety and soundness of the covered banking entities and banking system at large than any other piece of legislation since Glass Steagall. This is surely the greatest benefit of all.

## IV. COVERED FUNDS

In their allowances for the continued provision of Asset Management and Investment Advisory services to covered funds by banking entities, Congress granted a boon to the financial industry at the expense of the American public.

While the intent of the statute's allowances for Asset Management may have been justifiable, in reality these anticipated allowances are being used by the banking entities to simply shift proprietary trading from inside their walls to outside, with a healthy amount of ownership interests maintained to keep their involvement profitable.

CNBC reported back in March of 2011—in the appropriately titled article *Prop Trading Moves Down the Hall at JPMorgan*—that "JPMorgan is moving its proprietary trading unit out of its investment banking division and into its asset management division" and that it expected to seed the group with $2 billion of capital.[91] A September 2011 issue of *Invest Hedge* magazine confirms the earlier story in a profile on J.P. Morgan's Alternative Asset Management division that states that the bank's proprietary trading "is migrating from investment banking to asset management to comply with the Volcker rule."[92]

As we shall discuss below, the exemption for asset management and the abundant allowances for investments in covered funds not counted towards the 3% ownership limit (i.e., personal investments, broadly permitted risk-mitigating hedging and carried interest), all combine to pose a threat to the financial stability of the United States.

### A. Definitions

#### 1. Covered Fund

While we support the current definition of "covered fund" as defined in §§ _.10(b)(1)(i)-(iv) of the NPR, we feel that in *addition* to this definition, there could be a second, additive definition that allows the Agencies to include *other* funds not covered by § _.10(b)(1)(i) in the definition of covered fund.

Specifically, we suggest that the definition of "covered fund" be extended such that issuers identified in §§ _.10(b)(1)(i)-(iv) as well as *any* of the following issuers would qualify for the definition of a "covered fund":

> *§ _.10(b)(1)(v): An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for Section*

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[91] Ash Bennington, *Prop Trading Moves Down the Hall at JPMorgan*, CNBC: NetNet, Mar. 1, 2011, http://www.cnbc.com/id/41847719/Prop_Trading_Moves_Down_the_Hall_at_JPMorgan.

[92] Clair Makin, *Customization Takes Root at JP Morgan*, Invest Hedge, Sep. 2011, at 56, *available at* http://www.jpmorganinstitutional.com/cm/BlobServer/Invest_hedge_0911_article.pdf?blobkey=id&blobwhere=1321475157438&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

*3(c)(2) of that Act, or Rule 3a-1 or Rule 3a-6 of the Rules and Regulations promulgated under that Act, and*

*§ _.10(b)(1)(vi): Any issuer that the [Agency] deems to be a covered fund, should the Agencies deem that said issuer exhibit the characteristics of a fund that takes on proprietary trading activities;*

### 2. Carried Interest

We believe that carried interest should be included as an ownership interest. Carried interest is **not** mentioned in or provided for by the Volcker statute. The exemption of carried interest from the definition of ownership interest seems to have been added as a result of lobbying by the financial industry, and contradicts statutory intent. Carried interest is similar to a fee that tracks gains on price movements, which Volcker prohibits. Investment advisers should earn money through flat fees for customer service, rather than relying on what is essentially an option on the covered fund. Since "option" is included as one of the instruments in an "ownership interest," carried interest should also be included in that list.

Carried interest is also inappropriate because, facing no downside exposure, investment advisers are incented to take extremely risky bets that could debilitate a fund and require a bailout by the bank. There is a further conflict-ridden incentive for the banking employee investment advisor to encourage the banking entity to acquire as large an ownership interest as possible through a risk-mitigating compensation "hedge." The more assets under management ("AUM") the fund has, the larger the potential carried interest for the investment advisor employee.

Finally, the treatment of carried interest in the NPR is inconsistent with its tax treatment. One of the major arguments in favor of taxing carried interest at a capital gains rate, as is the current practice, is that carried interest **is** an ownership interest, but under the NPR it **not**. **Carried interest should not provide loopholes to banking entities and to covered funds in both the realm of taxation and the realm of regulation.** Thus, for this and all of the reasons we have outlined above, we strongly suggest that the Agencies **include carried interest in the definition of ownership interest**, as we suggest in *Annexure B.*

## B. Employee Ownership Interests in Covered Funds

We suggest that the Agencies **attribute to the banking entity any personal investments by a banking entity employee acting as investment advisor, regardless of the source of funds**. Failure to attribute personal ownership interest by an investment advisor working for the banking entity leaves room for improper incentives to bail out the covered fund should it reach dire straits. The Proposed Rule makes no limitations on self-funded, personal ownership interests held by banking entity employees working as investment advisers. For example, an investment adviser may be a majority or significant owner in the covered fund that she were advising. This advisor may be tempted to use her influence at the banking entity to provide assistance to the covered fund should it begin to falter.

In addition, § _.11(g) allows banking entity employees who provide "investment advisory or other services to the covered fund" to make personal investments in that fund. We ask that the Agencies **remove "or other services" from § _.11(g)**. The alleged purpose of the employee investment is to ensure that investment advisors have "skin in the game." The statute mentions no services other than investment advisory services, so the Proposed Rule is without authority in granting an exemption for "other services." In any case, non-advisor banking entity employees have no need to maintain "skin in the game," and this vague allowance could lead to directors or other high-ranking employees who may wish to earn profit on the fund's performance to provide a minimum service of any kind, and then freely invest in the fund. This has great potential to pollute the intent of Subpart C's restrictions.

## C. Congressional Intent Behind the Seeding Period, Section 619(d)(4)(i)

The allowances of the one-year seeding period provided by the NPR are susceptible to evasion of the restrictions and are substantially at odds with Congressional Intent.

The terms of § _.12(a)(1)(i) that allow the banking entity to provide "sufficient initial equity" provide no guidance as to what a "sufficient" investment means. Thus, banking entities may invest up to a maximum 3% of their Tier 1 capital during the seeding stage (assuming no other covered fund investments are present). This is no small sum for the nation's largest banking entities: in Q3 2011, 3% of J.P. Morgan's Tier 1 Capital measured **$3.6 billion**.[93]

Looking to the Congressional Record, Sen. Merkley gave specific guidance as to how the seeding period should work:

> As a general rule, firms taking advantage of this provision should maintain only small seed funds, likely to be **$5 to $10 million or less**. **Large funds** or funds that are not effectively marketed to investors **would be evasions of the restrictions of this section**.[94]

Failing to give specific guidance as to the scope and limits of the investments made during the seed period leaves enormous potential for exploitation and abuse of the intent of the Rule. Given the potential for an extension of this seed period for up to two years, a banking entity could be the sole owner of a covered fund, in the amount of $3 billion or more, for up to a total of three years, and still be well within the limits of the Rule. It is clear that the financial industry is already operating under the assumption that it will be given free reign in this seed year, with Goldman Sachs and Deutsche Bank getting in early in the seed investment "frenzy."[95]

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[93] News Release. JPMorgan Chase & Co.. JPMorgan Chase Reports Third-Quarter 2011 Net Income of $4.3 Billion, or $1.02 Per Share, on Revenue f $24.4 Billion, Bank-Owned Life Insurance (Oct. 13, 2011), *available at* http://files.shareholder.com/downloads/ONE/1608042267x0x508390/2ae4e2c9-f6ba-4ed8-be22-0fdf55c1f5c1/3Q11_JPM_EPR_FINAL.pdf.

[94] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (emphases added).

[95] Azam Ahmed, *A Boom in Starter Capital for Hedge Funds*, N.Y. Times Dealbook, Jan. 9, 2012, http://dealbook.nytimes.com/2012/01/09/a-boom-in-starter-capital-for-hedge-funds/.

We strongly suggest that the Agencies follow Congressional intent and require that **during the seed period, a banking entity's ownership interest must be capped at $10 million, or the 3% Tier 1 capital limit, whichever is less**.

## D. Other Permitted Investments in Covered Funds

### 1. Permitted Risk-Mitigating Hedging

We suggest that the Agencies **remove the permitted "hedging" of compensation arrangements** through an ownership interest in a covered fund provided by § _.13(b)(1)(i)(B), as it conflicts with the language of the statute.

However, should § _.13(b)(1)(i)(B) not be removed from the Final Rule, we suggest the following **new criteria** be added to § _.13(b)(2)(ii)(B)(2) in order to prevent rule evasion (additions in italics):

> § _.13(b)(2)(ii)(B)(2) is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, that covered fund, *provided that*:
>
> *(i) No "hedge" is permitted during the one year following the establishment of the fund.*
>
> *(ii) All proceeds from the "hedge" must be paid entirely to the investment advisor, and*
>
> *(iii) The "hedge" in the covered fund does not exceed 3 percent of the total outstanding ownership interests in the fund;*

There are two major problems with this risk-mitigating hedging of compensation arrangements. The first is that it is a clear **violation of the statute**. The second is that not only is such unfettered ownership interest hardly a hedge, but worse, **it is a loophole that would allow banking entities to subvert the Covered Funds restrictions almost entirely.**

#### *a. No Statutory Authority for Hedging Compensation Arrangements*

The statute does **not** provide for hedging "exposures" or "arrangements." Rather, the statute only permits hedging if it is directly tied to a position, contract or holding of a banking entity. Section 619(d)(1)(C) of the statute reads:

> Risk-mitigating hedging activities in connection with and related to **individual or aggregate 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 statute only permits hedging if it is directly tied to a **position, contract** or **holding** of a banking entity. The "positions, contracts or other holdings" language of the statute is related to

**items that go in the bank's *trading account*.** A compensation arrangement does **not** go into the trading account, and thus is outside the realm of the hedging exemption provided in Section 619(d)(1)(C) of the Act. Thus, we suggest that § _.13(b)(1)(i)(B) be removed from the Final Rule.

*b. Ownership Interests in Covered Funds are not a Hedge to Compensation Arrangements*

The notion that taking on an ownership in a covered fund would offset the "exposure" the bank has due to the banking employee being compensated with carried interest is shaky at best. Presumably, this "exposure" is to either the risk of a down year where no carried interest is earned, by the investment advisor, or the risk of a claw back to previous carried interest earned, or both.

The banking entity taking on an ownership interest in this same covered fund would hardly mitigate this "exposure." Instead, it is closer to doubling down. In up years, the employee or banking entity would receive compensation in the form of carried interest due to its services to the fund **and** due to its ownership interest. In down years, the employee or banking entity would not get paid and the banking entity's investment would **decrease in value.** The so-called "hedging" of a deferred compensation arrangement for an employee who is already paid through carried interest is such a stretch that **even SIFMA puts "hedges" in quotes**.[96]

The NPR insists that the "hedge" for the compensation arrangement "[m]aintains a substantially similar offsetting exposure to the same amount and type of ownership interest, 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."

However, the NPR provides no guidance on what constitutes an "offsetting exposure" to a compensation arrangement, instead deferring to the banking entities' "written hedging policies and procedures"[97] and their "internal controls."[98] Without such guidance, it seems that even a 100% ownership interest in a covered fund could be argued to be a risk-mitigating hedge under the NPR.

The permitted risk-mitigating hedging allowance as written is a means for banking entities to completely subvert the intent of the restrictions of Subpart C. Dangerous allowances have already been provided in the statute to permit banking entities to continue their profitable asset management business. In response, the banking entities have wasted no time ramping up these offerings, with Deutsche Bank teaming up with fund of funds Financial Risk Management,[99] and

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[96] SIFMA's Comment Letter in Advance of Notice of Proposed Rulemaking Implementing the Private Funds Portion of the Volcker Rule (Apr. 14, 2011), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=24745.
[97] Proposed Rule §_.13(b)(2)(ii)(D)(1).
[98] *Id.* at §_.13(b)(2)(ii)(A).
[99] Ahmed, *supra* note 95.

both Goldman Sachs[100] and J.P. Morgan re-drawing their org charts to move their proprietary trading units into asset management.[101] Rather than bow to pressure from SIFMA and the financial sector as a whole, the Agencies must remain true to the statutory definition of "hedge" and remove § _.13(b)(1)(i)(B) from the Proposed Rule, or at a minimum, include the additional criteria §§ _.13(b)(2)(ii)(B)(2)(i)-(iii) we have outlined in *Annexure B*. If the Agencies fail to do so, the banking entities will easily be able to sidestep the 3% limits by arguing that their ownership interests are simply necessary hedges.

### 2. Permitted Covered Fund Activities Outside the United States

We support the provisions of §§ _.13(c)(1) and (3), as they will prevent U.S. banks with foreign operations and subsidiaries from evading the Rule using the foreign funds exemption. They will also see to it that foreign banks with substantial U.S. operations comply with Volcker, and thus do not enjoy a competitive advantage over U.S.-domiciled banks. Finally, the provisions ensure that U.S.-based institutions cannot simply move all of their investments into foreign funds that need not adhere to the restrictions of the Volcker Rule. Failure to retain § _.13(c)(3)(iii) in the Final Rule could lead to a flight of (U.S.-resident owned) capital from the United States, and thus threaten economic growth and the financial stability of the United States.

We do ask that the Final Rule be clarified to more carefully define the terms used in the foreign fund criteria—§ _.13(c)(1), § _.13(c)(2) and § _.13(c)(3)—so as to eschew evasion based on mincing of words.

### 3. A Dangerously Broad and Statute-Violating Allowance in Loan Securitization

#### *a. Removal of § _.13(d)(2) and § _.14(a)(2)(v)(B)*

The exemptions for loan securitizations in § _.13(d) and § _.14(a) both contain the same dangerous item that allows not just for loans but also for **"contractual rights or assets directly arising from those loans supporting the asset-backed securities."**[102]

The statute allows for the sale and securitization of loans, and **only** for loans. The Final Rule should keep with the statute. Unfortunately, it interjects the language "contractual rights or assets directly arising from those loans," which is vague and broad enough that it could mean ABS, RMBS, CDS, or any other loan-derived product, making what is permitted by these exemptions far broader than what was directed by the statute.

There is explicit language in footnote 309 in the Supplementary Information stressing that:

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[100] Charlie Gasparino, *Goldman Already a Step Ahead of FinReg*, Fox Business News, July 27, 2010, http://www.foxbusiness.com/markets/2010/07/27/goldman-step-ahead-finreg/.
[101] Bennington, *supra* note 91.
[102] Proposed Rule §§ _.13(d)(2), _.14(a)(2)(v)(B).

> the types of derivatives permitted under § _.13(d)(3) of the Proposed Rule are not meant to include a synthetic securitization or a securitization of derivatives, but rather to include those derivatives that are used to hedge foreign exchange or interest rate risk resulting from loans held by the issuer of asset-backed securities.

This language is promising at first glance, but a close examination reveals that it refers only to § _.13(d)(3), which allows for "[i]nterest rate or foreign exchange derivatives," and **does not** refer to the language of § _.13(d)(2), which is the real problematic language that could include a synthetic securitization or a securitization of derivatives. After all, what are CDO-squared securities if not "contractual rights or assets directly arising from those loans supporting the asset-backed securities"?

The statute only allows for the sale and securitization of loans and thus the Proposed Rule should only allow for the sale of loans and loan securitizations. The language of § _.13(d)(2) and § _.14(a)(2)(v)(B) go far beyond the statutory intent. "Contractual rights or assets directly arising from those loans" could mean ABS, RMBS, CDS, or any other product, making what is allowed by these exemptions far and above what was directed by the statute. For instance, this language would create a blanket exemption for a hybrid-synthetic securitization whereby an SPV issues securities backed by certain loans and credit default swaps tied to those loans. Such credit default swaps would qualify as contracts arising from loans.

A review of the Congressional Record reveals that Congress did not intend the securitization rule of construction to include loans that "become financial instruments traded to capture the change in their market value."[103] Thus, in order to prevent a broad loophole allowing banks to have ownership interests in ABS issuers creating the same toxic products that caused the 2008 financial crisis, and in order to remain true to the statute, the Final Rule **must remove** both § _.13(d)(2) and § _.14(a)(2)(v)(B).

If § _.13(d)(2) and § _.14(a)(2)(v)(B) are not removed, they must at a minimum be made more explicit, making it clear that credit default swaps, total return swaps and any form of repos are specifically excluded from the exemption for loan securitizations.

#### *b. Further Delineation of the Statutory Rule of Construction for Loan Securitizations*

The removal of § _.13(d)(2) and § _.14(a)(2)(v)(B) is but a necessary, first-step. We recommend that the Agencies take bold action to further circumscribe the role that banking entities play in the securitization market, within the limits imposed by the rule of construction contained in section 13(g)(2) of the BHC Act.

In order to properly define the scope of the statutory rule of construction for securitizations, we propose that the Agencies adopt the following three-part definition of "ownership interest" in an exempted asset-backed security:

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[103] 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

First, any "ownership interest" by a banking entity in a SPV should fit the definition of "asset-backed security" in Regulation AB. This definition would require that the ABS be registered under the 1934 Securities Exchange Act, and would also require that the ABS not be a synthetic ABS, as synthetics are explicitly excluded from Regulation AB's ambit:

> [S]o-called 'synthetic' securitizations are not included in Regulation AB's basic definition of ABS for purposes of determining whether the security qualifies for the particularized registration, disclosure and reporting regime under the Securities Act and Exchange Act we are adopting today.[104]

Because the Proposed Rule explicitly allows banking entities to sponsor or acquire ownership interests in covered funds that are ABS issuers[105] we strongly suggest that the definition from Regulation AB be used to define an ABS.

Banking entities should not be allowed to acquire interests in covered funds that issue the very products responsible for the meltdown in 2008, as such an allowance would pose a threat to the safety of the financial system. Thus, we recommend Regulation AB as the definitional source for "asset backed security" under the Volcker Rule because the Reg. AB definition excludes synthetic securitizations. This definition would protect the stability of the banking and financial markets by preventing banking entities from owning covered funds that participate in synthetic securitizations.

Second, the Agencies should further require that any ownership interest in an SPV (issuer of an asset-backed security) be in equity only. As a preliminary matter, the Agencies should apply a three-factor economic test in order to determine whether a banking entity has an "ownership interest" in a covered fund. Meeting any of the following three factors should be sufficient to count as indicative of an "ownership interest" generally:

- The banking entity has control over the fund
- The banking entity has residual interest in the fund, OR
- The banking entity has access to distributions from the fund's excess cash flow.

Conversely, in order for an ownership interest in an ABS issuer to qualify for the exemption provided by § _.13(d) and § _.14(a)(2)(v), we recommend that all three of the above factors must be met. This interpretation would ensure that an exemption is provided only for bona fide loan securitizations in which the banking entity is actively involved, consistent with the Congressional rule of construction. Otherwise, an exemption for passive utilization of securitization vehicles would be a conduit for proprietary trading.

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[104] Asset-Backed Securities, Exchange Act Release Nos. 33-8518; 34-509405 (Mar. 8, 2005), *available at* http://www.sec.gov/rules/final/33-8518.htm.
[105] *See* Proposed Rule §§ _.13(d), _.14(a)(2)(v).

Third, the Agencies should require that any ownership interest in an SPV be capped at 5% of the residual, first-loss position in the SPV. This would allow banking entities to meet the requirements of § 941 of the Act.

### E. Tier-One Capital Constraints – "Skin in the Game"

In order to adhere with Dodd-Frank Act § 941, ABS issuers are required to maintain at least a 5% ownership interest in issued securities. The NPR does not provide sufficient clarity on how this "skin in the game" requirement interfaces with the 3% tier-one capital constraint on investment in covered funds. We would like it to be made explicit in the Final Rule that any ownership interest exceeding this 5% mandate would count towards the 3% tier-one capital constraint.

### F. Covered Fund Activities Determined to be Permissible - Bank Owned Life Insurance

We suggest that the Agencies remove the exemption for bank owned life insurance, as it does **not** promote the safety and soundness of banking entities or the financial stability of the United States. Past class action lawsuits settlements demonstrate that there is substantial risk of litigation. In addition, bank owned life insurance could pose a liquidity risk to the bank, as the OCC and other agencies warned in 2004.[106] Finally, it seems an egregious misuse of the authority presented by Section 13(d)(1)(J) of the BHC Act to give banking entities a blanket exemption for bank owned life insurance policies that have been shown to include "dead peasant" policies[107] that reward banks, often tax-free, when an employee dies. Thus, we do not believe there is statutory authority for the bank owned life insurance exemption, and suggest it be removed from the Final Rule. We remind the Agencies that, as per Congressional intent, Section 13(d)(1)(J) "sets an extremely high bar."[108]

### G. Limitations on Relationships with a Covered Fund

#### 1. Super 23A

We **strongly support** the "Super 23A" restriction in § _.16(a)(1). Preventing banking entities from extending credit to the covered fund is important to ensure that banking entities are not tempted to bail out a covered fund should it falter.

That said, we are concerned that § _.16(a)(1) **does** allow for the **sale** of securities by a banking entity to a covered fund. The Agencies should consider a scenario where a banking entity organizes, offers, and seeds a new fund, and then sells a substantial amount of assets to this new

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[106] Interagency Statement on the Purchase and Risk Management of Life Insurance, OCC Bulletin No. 2004-56 (Dec. 7, 2004); FDIC FIL-127-2004 (Dec. 7, 2004); Federal Reserve Board SR Letter No. 04-19 (Dec. 7, 2004); OTS TB 84 (Dec. 14, 2004).

[107] *See* Ashby Jones, *Dead Peasant' Policies: The Next Big Thing in Insurance Litigation*, Wall St. J., Feb. 24, 2009, http://blogs.wsj.com/law/2009/02/24/dead-peasant-policies-the-next-big-thing-in-insurance-litigation.

[108] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

fund. We are concerned that, as written, the NPR's allowance for the sale of securities by the banking entity to the covered fund may allow for duplicitous accounting. Thus, in addition to supporting the restrictions provided by § _.16(a)(1), we suggest that the Agencies issue an **additional** restriction that would prevent a banking entity from **selling assets** to a covered fund. The unfettered ability of a banking entity to offload undesirable assets to subsidiary covered funds would only create incentives for such a banking entity to take higher levels of risk and pursue speculative assets.

### 2. Prime Brokerage Transaction Must Be Limited To Third Party Funds

The Congressional Record shows that the intention behind the allowances for prime brokerage in the statute was meant to be applied to **third-party funds only.**[109]

The language of the Proposed Rule does not implement this Congressional intent, and thus must be modified to reflect that the prime brokerage allowance was only meant for third-party funds. In order to amend this breach between Congressional intent and the NPR, the Final Rule should amend § _.16(a)(2)(ii) to include the phrase "third party":

> (ii) Enter into any prime brokerage transaction with any *third party* covered fund in which a covered fund managed, sponsored, or advised by such covered banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest, if:

### 3. No Financing or Securities Lending in Permitted Prime Brokerage Transactions

We strongly suggest that the permitted prime brokerage transactions listed in § _.16(a)(2)(ii) **should not include** securities lending and borrowing, or financing.

Neither the Congressional Record nor the statute state that the exception for prime brokerage must include financing, securities lending or borrowing. We feel that there are considerable risks in allowing "financing" of a covered fund by a banking entity, as this may lead to the fund increasing its leverage. Finally, the statute very clearly laid out the fact that Sections 23A and 23B of the Federal Reserve Act would be used for the purpose of prohibiting "covered transactions" between a banking entity and a covered fund. One of the covered transactions described in 23A is "a loan or extension of credit."

We also suggest that a banking entity be required to reduce its ownership interest to the 3% *de minimis* limit before it is allowed to serve as a prime broker to the covered fund.

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[109] *Id.* at S5898 ("Subsection (f), paragraph (3) permits the Board to allow a very limited exception to paragraph (1) for the provision of certain limited services under the rubric of 'prime brokerage' between the banking entity and a third- party-advised fund in which the fund managed, sponsored, or advised by the banking entity has taken an ownership interest.").

### 4. 23B and Market Terms for Prime Brokerage Transactions

Despite our issues with the prime brokerage transaction allowances, **we strongly support the requirements outlined in § _.16(b) and § _.16(c),** which require that services and transactions between the banking entity and a covered fund to be on market terms or on terms at least as favorable to the banking entity and the covered fund "as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies."[110]

Were § _.16(b) and § _.16(c) not present in the Rule, a banking entity could sell distressed assets to a covered fund at above-market prices. We feel it is very important to retain § _.16(b) and § _.16(c) in the Final Rule in order to prohibit abuses of the covered fund exemptions.

[110] 12 U.S.C. § 371c–1(a)(1)(A) (2011).

# V. RECORD-KEEPING AND COMPLIANCE

## A. Reporting Scope and Timeline

### 1. Excluded Activities Must Also Require Reporting

One of our chief concerns with the Rule as written is that it threatens in some cases to not just enable but also incentivize certain types of evasion. For that reason, we feel it is imperative that **all** trading, regardless of any trading account exclusion, be subject to quantitative-measurement and risk-reporting requirements. Excluding currently traded instruments, such as structured repurchase and reverse repurchase agreements, from measurement and reporting requirements will create a major incentive for banking entities to engage in risky "financial engineering" in order to evade requirements.

### 2. Clarification of the $1 Billion Threshold Calculation

Our understanding is that the NPR considers only "covered trading activities" as counting toward the $1 billion threshold that triggers the reporting and record-keeping requirements of the Volcker Rule. For similar reasons to those quoted above, we feel that the Agencies should instead ensure that **all assets and liabilities defined as trading assets for purposes of the Market Risk Capital Rule are included in the $1 billion standard** for triggering the Rule's reporting and record-keeping requirements.

### 3. Reporting Should Begin Immediately

It is our strong conviction that the stated timeframe for beginning the reporting requirements is more than adequate. Within the banking industry, it is general knowledge that the 2008 financial crisis inspired almost all banking entities to begin drafting institutional aggregate risk-measurement programs. With this in mind, it seems that any complaints about overaggressive implementation schedules are likely to be politically rather than functionally motivated.

### 4. Recordkeeping Requirement Consistency

While we feel that the proposed retention-of-records requirement[111] is a necessary concept and should be retained, we do feel that it is currently inconsistent with relevant state laws. While the current statute of limitations on civil suits for Fraud, Contracts and Collection of Debt on Accounts in New York State is **six** years,[112] the proposed language only requires the retention of records for "no less than 5 years." Given the significant financial-industry presence in New York, we feel that the NPR should ensure that the minimum record-retention language is consistent with the New York State law cited above.

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[111] Proposed Rule § _.20(b)(6).
[112] N.Y. Civ. Prac. L. & R. § 213 (2012).

We have added this suggested change to *Annexure B.*[113]

### 5. Clarification of Vague Language

We feel that § _.20(b)(1), requiring "[i]nternal written policies and procedures reasonably designed"[114] to ensure compliance with the NPR, could be further strengthened. Specifically, we feel that linking the language on "reasonable assurance" and "reasonableness" to similar existing language in Sarbanes-Oxley[115] would make the Proposed Rule both more effective and more consistent with other regulation.

Language in Appendix C, Element III could also be made clearer. In a delineation of minimum criteria, the Rule states that when any quantitative measurement raises a concern regarding compliance with section 13 of the BHC Act, there should be both an immediate internal review and escalation, and "timely notification to [Agency]."[116] We feel that "timely" is insufficiently clear here. We feel that the Rule should directly require the banking entity to **immediately** notify the [Agency]. For additional clarity, we recommend that the Agencies explicitly require such notification to occur no later than one day after the concern is raised internally.

As long as banking entities are complying with the Rule, this requirement should not be unduly burdensome. The robust internal reporting measures necessary should already be in place.

## B. Structure of Programmatic Compliance Regimes

### 1. Internal vs External Independent Testing

Although we are strong supporters of the fourth listed element, independent testing, we have concerns about the practical implementations of both listed approaches. We therefore urge the Agencies to conduct monitoring of each approach with extreme vigilance.

With respect to internal testing, we feel testing by qualified banking entity personnel will be most effective if performed by a banking entity's Internal Audit personnel. These employees, usually respected (and appropriately feared) within a banking entity, have the auditing expertise, internal authority, and institutional knowledge required to conduct effective testing. Since the NPR does not provide clear monetary penalties, however, we are concerned that internal audit teams may lack the usual incentive (avoiding substantial loss to the firm from monetary sanctions) that ensures their zealous enforcement of other regulatory provisions.

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[113] The proposed elements are generally very effective and should all be retained in the Final Rule. It is important to retain them because failure to do so would make evasion of the rule substantially easier.
[114] Proposed Rule §_.20(b)(1).
[115] *See* Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 72 Fed. Reg. 35,324, 35,324 (June 27, 2007) (codified at 17 C.F.R. pt. 241 (2008)).
[116] NPR at 68,966.

With respect to external testing, we are concerned about an outside parties' lack of firm-specific knowledge. While we do not doubt that these outside entities will scrupulously carry out their measurements, we feel that their lack of expertise in areas such as account structuring, technological specifics, and unit responsibilities will make it difficult for them conduct effective reviews. Regardless of which approach a banking entity uses to comply with § _.20(b)(4), we ask that the Agencies remain vigilant and ensure that the implementation of any testing is adequate.

As an alternative, we suggest that the Rule require regular monitoring by the internal audit team, supplemented by yearly external reviews with strict, verified independence. Additionally, we would suggest that all internal compliance professionals be subject to a Volcker-specific licensing and registration process similar to FINRA's Series 14[117] for NYSE compliance officers. Such standardized licensing processes ensure that a basic level of proper skills, knowledge, and accountability is shared by all relevant personnel throughout the industry.

### 2. Enterprise-wide Compliance Programs

Since all divisions of the banking entity will be involved in the record-keeping and decision-making required by certain sections of the rule, including Appendix C's elements VI (training), Internal Policies and Procedures (II) and Record Keeping (VII), we feel that these sections would fit excellently into an enterprise-wide compliance program. However, it is our opinion that an enterprise-wide compliance program will only be effective if combined with additional programs at the trading unit or subsidiary level.

In our collective experience working at banking entities, the most successful enterprise-wide compliance programs we have encountered are the anti-money-laundering and anti-sexual-harassment training programs offered at financial institutions. Since all employees are required to learn the risks, indicators and possible consequences of money laundering, these programs generally achieve excellent results. A similar program, combining electronic informational materials and a progression of case studies with attendant questions, might be effective in ensuring Volcker Rule compliance. Any such training program should be sure to train all employees at a banking entity in prohibited activities, permitted activities, and next steps in the event of a suspected violation.

We do not believe that Appendix C's elements III (Internal Controls), IV (Responsibility and Accountability), V (Independent Testing) and VII (Record Keeping) should occur solely at the enterprise level. In Element IV (Responsibility and Accountability), for example, the NPR outlines many specific levels of responsibility (including Trader Mandates and Business Line Managers) that would be difficult or impossible to track solely at an enterprise-wide level.

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[117] The Series 14 examination, administered by FINRA, is a qualification examination intended to insure that the individuals designated as having day-to-day compliance responsibilities for their respective firms or who supervise ten or more people engaged in compliance activities have the knowledge necessary to carry out their job responsibilities. FINRA, FINRA Registration and Examination Requirements, http://www.finra.org/industry/compliance/registration/qualificationsexams/registeredreps/p011051 (last visited Feb. 5, 2012).

Mandates from high in an organizational hierarchy may not address the specifics of an individual business line. Compliance with hedging exemption criteria will be much different for Global Corporate Bond Trading units than for European Equity Derivatives units.

For this reason, we believe enforcement must occur at the enterprise-wide and department-specific levels. Enterprise-only enforcement may dilute materiality at unit levels: a material breach at a subsidiary unit may not be material at the enterprise level. To prevent individual desks with small dealings from evading the Rule, then, any Internal Control program should also be present at the trading unit level with oversight from senior management, compliance, and internal audit officials.

We feel it would be inefficient to mandate an enterprise-wide model of Internal Controls. Since each trading unit is different, quantitative measures may vary widely in their value and applicability to each individual unit. We suggest it would be more efficient to mandate enterprise-wide default Internal Controls, but require each individual trading unit to tailor these requirements to its own specific business. This tailoring, performed with the consent of internal compliance workers, would ensure that trading units do not attempt to subvert the Rule.

### 3. Burdens and Redundancies

It is likely that a vast majority of banking entities have existing compliance programs that are not substantially different in structure from the one described in this Proposed Rule. The level of detail, however, can be expected to diminish commensurate with levels of risk exposure.

If banking entities willingly and seriously move to implement the necessary changes to their relevant businesses to conform to these rules, there should be minimal need for substantial changes to current compliance staff. If, however, banking entities move to restructure in order to subvert or evade the regulation, the job of the compliance department will become exponentially more difficult, and under these circumstances compliance departments may require substantial additional resources.

In our general opinion, the specific requirements of this Proposed Rule are sufficiently basic that if meeting these standards for a given trading activity poses a significant burden on a banking entity, then that trading activity would most likely be considered inappropriate for it to conduct in any case.

Any truly thorough system will include a certain amount of overlap, and we find no redundancies in the Proposed Rule that do not serve to strengthen the overall program. The requirements in each Appendix are mutually reinforcing. For example, the quantitative measurements do much to provide an overview of a trading unit's risk profile, but fail to identify inappropriate hedging activity. The compliance requirements in Appendix C provide much more specific information as to the nature of compliant trading activity. While each provision separately may not provide sufficient clarity for an analysis of an entity's general compliance, in concert they seem to provide robust regulatory coverage.

### 4. CEO Certification

We recommend that, consistent with the recommendations of the FSOC Study, CEOs should be required to provide yearly certification that the compliance program is adequate and effective, as this will "ensure the highest level of accountability."[118] It is our strong conviction that it will be difficult to effect real change at banking entities without committed leadership from the very top. This provision, in addition to being extremely practical, does nothing but hold banking entity executives to the same standards that many Americans in other sectors of the economy meet each day: taking responsibility for the work that occurs under their watch.

We also call for the establishment of a central repository for CEO attestations to the Agencies. In addition, the Agencies should require that Question 346's suggested supervisory methods (i), (ii) and (iii),[119] be adopted and implemented by the banking entities. The use of these thorough procedures within the banking entity's supervisory channels will ensure that the Agencies, often constrained by limited resources,[120] are included in the compliance process in the most effective way possible.

## C. Special Concerns

### 1. Reporting and Compliance for ABS Issuers

In light of recent and ongoing scandals in the mortgage market specifically,[121] it is clear that negligent record keeping and minimal oversight would present significant challenges to the implementation of the proposed compliance regime. While this would certainly be problematic, it is the clearest possible demonstration of the dire importance of ***all*** banking entities adhering to such a system. Since mortgage securities are often the riskiest within existing ABS issuer portfolios, we feel it would be tremendously irresponsible of the Agencies to lose their focus on these issues. We urge the abandonment of any inclination to relax these requirements for any trading activities.

In our view, banking entities that own existing issuers of asset-backed securities must face a choice. Either banks must find a way to fully comply with the Proposed Rule's requirements, or they must divest their ownership in such issuers. A blanket exclusion for existing asset-backed-

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[118] FSOC Study, *supra* note 29. at 36 ("Agencies should also strongly consider requiring the CEO to attest publicly to the ongoing effectiveness of the internal compliance regime. This will ensure the highest level of accountability for the satisfaction of these expectations.").

[119] NPR at 68.922 (Question 346) ("(i) A chief compliance officer or similar officer present an annual compliance report including, as appropriate, recommended actions to be taken by the banking entity to improve compliance or correct any compliance deficiencies; (ii) the board review any such recommendations and determine whether to approve them; and (iii) the banking entity notify the relevant Agency if the board declines to approve such recommendations, or approves different actions than those recommended in the compliance report.").

[120] FSOC Study, *supra* note 29. at 44 ("[S]ome Agencies face significant resource constraints and that incorporation of these components, which include a review of trading practices to identify prohibited trading and distinguish permissible trading, would require significant new and specialized resources.").

[121] *See* Brady Dennis & Ariana Eunjung Cha, *In Foreclosure Controversy, Problems Run Deeper than Flawed Paperwork*, Washington Post, Oct. 7, 2010, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/10/06/AR2010100607227.html.

security issuers is clearly at odds with the intentions of the statute to promote transparency and oversight in risky securities. We believe the Agencies should not be concerned with the means by which these necessary compliance procedures are internally funded.

# VI. LIMITATIONS ON PERMITTED ACTIVITIES

## A. Conflicts-of-Interest

### 1. Conflicts with Depositors

Based on *current* banking practice, market making, underwriting, hedged trading, and the rest of the permitted activities listed in Section 619(d)(1) all run afoul of the limitation contained in Section 619(d)(2)(A)(i). That limitation states that banking entities may not rely on any Volcker Rule exclusion if doing so would result in a material conflict of interest with "customers." Depositors should fall within the definition of "customers" since banks provide them with depository services. Virtually all banking entities that engage in market making and other exempted activities fund these activities, at least indirectly, with depositors' funds. However, depositors are never compensated for the usage of their funds when banks earn money from proprietary positions, which is a conflict of interest.

When depositors post money at banks, that money does not remain in a vault. Rather, it is utilized by banking entities to make loans, pay off expenses, and otherwise create an infrastructure through which to *conduct proprietary trades*. Thus, banks stand to gain from the leverage provided to them by depositors. Unfortunately for depositors, this provision of leverage remains uncompensated. This point was cogently recognized by Congressman Keith Ellison during the Congressional House Committee on Financial Services' recent hearing on the Volcker Rule:

> In the absence of something like Volcker Rule, we have a head I win, tails you lose system in which, if I'm a bank I can go out and buy mortgage-backed securities ("Triple A rated") . . . they make a bunch of money, I keep that, I do not give that to those depositors, [whose money] I use. . . . But if I lose a bunch of money, I'm coming to the taxpayer to save me. And it seems so unfair.[122]

Burton's Legal Thesaurus states that a "conflict of interest" exists where a party faces a divergence of interests with respect to clients.[123] We know of no bank that repays FDIC-insured depositors for usage of their money in the form of participation interests on the proceeds from proprietary trading. This is an exploitative situation wherein the resources of one party are utilized by another, without just compensation—a clear "divergence of interests." Thus, simple logic dictates that depositors must be granted some monetary participation in any gains achieved by a banking entity from exempted activities like market making. Absent such a participation, Section 619(d)(2)(A)(i) would bar <u>all</u> proprietary trading by covered banking entities.

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[122] U.S. House, Committee on Financial Services, *Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Hearing*, Jan. 18, 2012, *available at* http://mfile3.akamai.com/65722/wmv/sos1467-1.streamos.download.akamai.com/65726/hearing011812.asx.

[123] William C. Burton, Burton's Legal Thesaurus (2007).

### 2. Congressional Intent Behind Section 619(d)(2)(A)(i)

Even if the Agencies decline to adopt this interpretation, we have various other concerns with the Proposed Rule's implementation of the Section 619(d)(2)(A)(i) backstop. For instance, the Agencies have impermissibly interposed disclosure and information barriers into the Proposed Rule as curative measures to address conflicts-of-interest. Section 619(d)(2) contains no mention of information barriers or disclosure, and it appears that the Agencies have added these components into the conflict-of-interest backstop without any statutory justification.

There is evidence that Congress purposely excluded disclosure and information barriers as rehabilitative measures to address conflicts of interest. First, the Congressional Record relating to the passage of Section 619 is devoid of any mention of these concepts. Second, the legislative intent behind Section 621, which is indirectly related to and was passed alongside Section 619, is illuminating on this point. Senator Levin expressly rejected the usage of disclosure as potentially curative of conflicts of interests in asset-backed security underwritings:

> [A] firm that underwrites an asset-backed security would run afoul of the provision if it also takes the short position in a synthetic asset-backed security that references the same assets it created. In such an instance, even a disclosure to the purchaser of the underlying asset-backed security that the underwriter has or might in the future bet against the security will not cure the material conflict of interest.[124]

Congress had the opportunity to include disclosure and information barriers into Section 619, and it chose not to do so. The Agencies must follow suit. An administrative agency exceeds its authority when it considers regulatory options that have been purposely dismissed by Congress.[125]

### 3. The Ineffectiveness of Disclosure

Disclosure is an ineffective remedy for numerous reasons. First, disclosure has limited utility where the potential wrongdoer is the party that is given the responsibility of providing the relevant information to investors. If a banking entity has engineered a proprietary trade with the express intention of taking advantage of customers, it will not meaningfully disclose that fact. Banks will only willingly disclose meaningless or benign information. In a recent speech at Fordham Law School, Securities and Exchange Commissioner Troy A. Paredes recognized that disclosure can be useless in some cases, especially where the sheer volume of the disclosed material militates against actual comprehension of risk.[126] Even where disclosed information is meaningful, the relevant bits of information may be buried in a sea of paper that would

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[124] 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).
[125] *See Levine v. Apker*, 455 F.3d 71, 80 (2d Cir. 2006) ("[W]e will not defer to an agency's interpretation that contravenes Congress' unambiguously expressed intent.").
[126] *See* Troy A. Paredes, Address at Twelfth Annual A. A. Sommer, Jr. Lecture on Corporate, Securities and Financial Law, Fordham Law School (Oct. 27, 2011) (speech given in Securities and Exchange Commissioner Paredes's individual capacity).

effectively pre-empt actual comprehension of risk by investors. For instance, in its investigation of Citigroup's Class V Funding III collateralized debt obligation ("CDO"), the SEC learned that Citigroup had disclosed to investors in its pitch book and offering circular that it had taken a short position in the underlying credit derivative.[127] The SEC nevertheless continued the investigation, which culminated in a $285 million settlement.[128]

Disclosure is particularly ineffective in illiquid markets because these markets typically feature information asymmetries or pricing obscurities. Banking entities with even the best of intentions simply may not have enough information to disclose material conflicts-of-interest. The example of Long Term Capital Management will demonstrate that even sophisticated parties may not be aware of or fully appreciate the risks involved in their own activities.[129]

Further, even if banking entities were able to identify and disclose conflicts of interest in their proprietary trading activities, their customers may not be able to appreciate or digest such disclosures. The savviest of institutional investors may not have sufficient resources or access to information to verify the contents of disclosure documents, especially within the context of highly illiquid markets. Many investors simply presume that disclosed information is accurate, relying on the underwriter's reputation as an information proxy.[130]

At § _.8(b)(1)(ii), the Proposed Rule further dilutes the impact of the conflict-of-interest backstop, by allowing disclosures to "negate**, or substantially mitigate,** any materially adverse effect on the client."[131] If the Agencies retain a role for disclosure as curative of conflicts-of-interest, despite the above-mentioned arguments, they should at the very least strike ", or substantially mitigate," out of § _.8(b)(1)(ii). Put simply, banks should be required to negate any materially adverse effects on clients, and not just "substantially mitigate" those effects. A "substantial mitigation" standard would effectively condone minor-yet-materially adverse effects of conflicts of interest on banking clients. This interpretation is at odds with the customer-focused motivation behind the Volcker Rule.

### 4. The Ineffectiveness of Information Barriers

Information barriers also have limited usefulness in curing conflicts-of-interest. The NPR notes that information barriers are currently used as a means to address conflicts-of-interest in other securities law contexts. The implication is that these information barriers are effective tools in promoting a culture in which the interests of investors are paramount and sensitive information is not exploited for gain. However, despite the existence of these barriers, front running occurs routinely. Every few months the financial pages are replete with stories of how so-called "rogue

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[127] *Sec. & Exch. Comm'n v. Citigroup Global Markets Inc.*, SEC Litigation Release No. 22134 (Oct. 19, 2011).
[128] *Id.* The Southern District of New York later rejected the SEC's application to confirm this paltry settlement figure, because such a confirmation would turn the courts into "an agent of oppression." *See SEC v. Citigroup Global Markets Inc.*, Case No. 11 Civ. 7387, slip op. at 15 (S.D.N.Y. filed Nov. 28, 2011).
[129] *See generally* Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (2001).
[130] Andrew T. Tuch, Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs 57 (Apr. 2011), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Tuch_37.pdf.
[131] Proposed Rule § _.8(b)(1)(ii) (emphasis added).

traders" are able to circumvent information barriers and other controls to lose billions of dollars in highly risky transactions, at the expense of clients.[132] Academics have also amassed empirical evidence questioning the efficacy of information barriers.[133] Such studies have found that even where information barriers are erected, regulators are routinely unaware of when such barriers have been breached.[134] Information barriers are a regulatory tautology, in that regulated entities are essentially asked to police themselves and to report non-compliance.[135]

In some cases, information barriers actually undermine the efficacy of disclosure as a tool to cure conflicts of interest. In a recent class-action lawsuit, J.P. Morgan Chase ("JPM") was sued by former investors in a troubled investment vehicle called Sigma.[136] The plaintiffs in that lawsuit alleged that JPM knew about Sigma's impending demise, yet failed to alert them of that fact. JPM made handsome profits from the collateral held by Sigma after that investment vehicle ultimately failed. This case seems to present a classic case of conflict of interest. However, JPM has argued in court that its information barriers actually **precluded** it from providing the plaintiffs with the disclosures necessary to protect their interests.[137] "The bank argues that by law, different units of the company that dealt with Sigma could not share information, because of so-called Chinese walls, which are meant to prevent the spread of nonpublic information within the firm."[138] If JPM is to be believed, information barriers actually make conflict mitigation more difficult, especially where conflicts arise from activities in different units within a banking conglomerate. Therefore, the Agencies should seriously question whether information barriers have any curative utility in conflicted transactions.

### 5. Enforcement: Limitation on Banking Entity Size

The conflict of interest limitation can also be seen as a jurisdictional justification for the imposition of size limits on banking entities that seek to conduct covered activities under one of the exemptions. Opportunities for front running abound in larger organizations. At larger banks, it is easier to couch front running as mere fortuitous gains derived from independently acquired information. This kind of obfuscation is more difficult in smaller banks, since customers are likely to have more visibility into a smaller bank's operations. As the JPM-Sigma case demonstrates, the larger the bank, the easier it is for that bank to claim that assertedly conflicted actions were justified by the presence of information barriers. We recommend that the Agencies impose a size restriction on banking entities relying on a proprietary trading exemption. A

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[132] Jesse Eisinger, Propublica, *In Fight Against Securities Fraud, S.E.C. Sends Wrong Signal*, N.Y. Times Dealbook, Oct. 26, 2011, http://dealbook.nytimes.com/2011/10/26/in-fight-against-securities-fraud-s-e-c-sends-wrong-signal/.
[133] *See* Tuch, *supra* note 130, at 32.
[134] *Id.*
[135] *See* David S. Hilzenrath, *Justice Department, SEC Investigations Often Rely on Companies' Internal Probes*, Washington Post, May 22, 2011, *available at* http://www.washingtonpost.com/business/economy/justice-department-sec-investigations-often-rely-on-companies-internal-probes/2011/04/26/AFO2HP9G_story.html ("As the U.S. government steps up investigations of companies suspected of paying bribes overseas, law enforcement officials are leaving much of the detective work to the very corporations under suspicion.").
[136] Louise Story, *JPMorgan Accused of Breaking Its Duty to Clients*, N.Y. Times, Apr. 10, 2011, http://www.nytimes.com/2011/04/11/business/economy/11bank.html.
[137] *Id.*
[138] *Id.*

suitable limitation would be $5 billion in trading assets and liabilities, which is the Proposed Rule's threshold for enhanced record-keeping duties. Such a restriction would be one of the most effective ways—certainly more effective than disclosure or information barriers—for banks to avoid conflicts of interest with clients.

### 6. Enforcement: Imposition of a Fiduciary Duty

The Proposed Rule's definition of conflict-of-interest is under-inclusive because it fails to sufficiently delineate the contours of what does and what does not constitute a conflict of interest. By creating a vague standard with little direct precedential value, the Agencies have not provided market participants with any usable guidelines with which to conform their conduct. We propose that the Agencies redress this deficiency by imposing an explicit fiduciary duty on any banking entity relying on a Section 619(d) exemption. Such an imposition is justified on two grounds:

a. the requirement that permitted proprietary trading be client-oriented is tantamount to the imposition of a fiduciary duty, and

b. the Section 619(d)(2)(A)(i) ban on conflicts of interest in permitted activities imposes a heightened relationship of trust between a bank and its client, consistent with a fiduciary standard.

#### *a. Client-oriented Activities*

In a normal arms-length transaction, a banking entity must only satisfy a relatively simple, anti-fraud standard in its dealings with clients and counterparties. In such transactions it is understood that the parties have divergent interests, and that one party does not safeguard the interests of the other. This arms-length scenario does **not** apply to transactions permitted under Section 619(d). That Section requires that any banking entity performing permitted proprietary trading activities meet a fiduciary standard with respect to its clients.

The Congressional Record reveals that the purpose behind the Section 619(d) exemption was to allow proprietary trades only if they were "safer, client-oriented financial services."[139] This focus on client-oriented services is markedly different from the typical arms-length relationship that undergirds most banking activities. In an arms-length transaction, the bank's focus is on its own bottom line. In a client-oriented transaction, the bank's focus must be on the client's bottom line; otherwise that transaction would not be "client-oriented." In other words, the legislative intent was to force banks conducting exempted activities to align their interests with those of their clients.

The client-oriented duty that is imposed on banking entities relying on Section 619(d) can fairly be described as a fiduciary duty. Black's Law Dictionary defines "fiduciary duty" as "a duty obligating a fiduciary (as an agent or trustee) to act with loyalty and honesty and in a manner

[139] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).

**consistent with the best interests of the beneficiary**."[140] That is, a fiduciary must promote the client's best interests. Similarly, as per Congressional intent, a banking entity operating under one of the Section 619(d) exemptions must also promote the client's best interests. Thus, Section 619(d)'s emphasis on the client's best interest is entirely consistent with the concept of fiduciary duty. Indeed, concern for another's interests ahead of one's own is the hallmark characteristic of a fiduciary duty.

*b. Heightened Relationship of Trust*

The Volcker statute also imposes a fiduciary standard by operation of the plain language of the conflict of interest backstop contained in Section 619(d)(2)(A)(i). That provision holds that activities otherwise permitted under Section 619(d) are banned if they would result in a "conflict of interest." This restriction contemplates a heightened relationship of trust between a bank and its client, which is consistent with a fiduciary standard.

The default rule for banks executing proprietary trades is that the bank is free to have gross conflicts of interest with its clients (provided there is no fraud). Section 619(d)(2)(A)(i) changes this default rule with respect to Section 619(d) exempted activities. By imposing a limitation on conflicts of interest, Section 619(d)(2)(A)(i) imposes a **heightened burden** on bank engaging in exempted activities. Under this heightened burden, a bank must align its interests with those of clients, so as to avoid material conflicts of interest. This alignment of interests, which is imposed by statute, is suggestive of a close, trusting relationship between the bank and its clients. As discussed above, the legislative history confirms that Congress intended to impose just this type of close, trusting relationship in this context. Case law holds that where clients expect a heightened level of trust from financial services providers, a fiduciary duty is imposed.[141] That is, the existence of a relationship of trust can give rise, *sua sponte*, to a fiduciary duty benefiting the client. Thus, it can be argued that Section 619(d)(2)(A)(i)'s limitation on conflicts of interest creates a fiduciary duty for any banking entity conducting exempted activities under Section 619(d).

This proposition is not unprecedented. In other areas of law, bans on conflict of interest go hand-in-hand with fiduciary duty. For example, in the context of corporate law, the fiduciary duty placed on a company's director requires a purposeful alignment of interests by that director. The director must refrain from privileging his personal financial interest over that of the corporation in making decisions.[142] In other words, the director must not allow a conflict of interest to taint his actions, as that would be a breach of fiduciary duty. Similarly, an attorney's

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[140] Merriam-Webster's Dictionary of Law (1996).

[141] *See Breakaway Solutions, Inc. v. Morgan Stanley & Co.*, No. Civ. A. 19522, 2005 WL 3488497, at *2 (Del. Ch. Dec. 8, 2005) (""To the extent that underwriters function, among other things, as expert advisors to their clients on market conditions, a fiduciary duty may exist."). *See also EBC I,Inc. v. Goldman, Sachs & Co.*, 19, 832 N.E.2d 26, 31 (2005) ("[A] cause of action for breach of fiduciary duty may survive, for pleading purposes, where the complaining party sets forth allegations that, apart from the terms of the contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone.").

[142] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) ("Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally").

fiduciary duties severely limit her ability to be involved in matters giving rise to a conflict of interest, given that a client's interest must be held as paramount.[143] Analogously, the Section 619(d)(2)(A)(i) conflict of interest limitation also requires an alignment of interests between bank and client, and is therefore consistent with the concept of fiduciary duty.

Practically speaking, a fiduciary duty would benefit both banks and the regulators charged with ensuring compliance with the Volcker Rule. The fiduciary standard is backed by centuries of interpretive common law. This well-established body of precedent would serve as an objective yardstick with which banking regulators and compliance officers could measure bank conduct. We are aware that Section 913 of the Act has raised the possibility of a uniform fiduciary standard for all financial advisers. Still, the Agencies should recognize that Section 619 imposes a fiduciary duty on banks for any Section 619(d) permitted activities, irrespective of and separate from Section 913.

### 7. Enforcement: Disgorgement of Principal Gains

The conflicts of interest provision justifies automatic disgorgement of money that banks earn from price movements while conducting Section 619(d) permitted activities.[144]

The Proposed Rule strains logic by claiming that "the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests would not be deemed a 'material' conflict of interest with respect to [Section 619(d) permitted] transactions." Frankly, this makes no sense. The fact that a buyer and seller are on opposite sides of a transaction **necessarily** means that they have a significant conflict simply because a typical trade between a buyer and seller is a zero-sum game. In fact, the two parties in a trade are materially[145] conflicted in their objectives whenever there is a possibility that one side will win, and the other side will lose on the transaction. The only permissible way that a bank and a client could be on different side of a transaction without there being a material conflict of interest is if the bank were to lose on the transaction **every time**. This presents the Agencies with two options:

1. Mandate that the Section 619(d) permitted activities can never be done if a banking entity is on one side of a transaction and its client is on the other side (in recognition of the fact that the bank will win sometimes, to the detriment of the client), or
2. Allow a bank and its client to be on opposite sides provided that the bank is required to disgorge to the client any profits made from the transaction. This would nullify the effects of the conflict.

It should be noted that the bank's fees for services would not be subject to disgorgement since there would be no conflict over such fees. The client has no legitimate right to the bank's fees for services rendered. However, the client certainly would have a right to claw back profits from price movements in retained principal risk.

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[143] ABA Model Rules of Prof'l Conduct R. 1.7.
[144] The tool of disgorgement is discussed above in the underwriting and market-making sections.
[145] Indeed, the prospect of gain (or loss) on a transaction is probably the most "material" aspect of any trade.

## B. High-Risk Assets

The Proposed Rule is ineffective because it does not properly define the term "high-risk asset." The term is defined to include "an asset or group of related assets that would, if held by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail."[146] The NPR perplexingly avoids explicitly defining the term to include "illiquid assets." Illiquid assets certainly fit the bill as assets that substantially increase the likelihood of bank failure. For proof, the Agencies need look no further than the example of Lehman Brothers, which collapsed largely under the weight of its risky bets in illiquid markets.[147]

Credit derivatives should also be designated, pro forma, as "high risk assets." The role that these instruments played in the recent financial crisis has been well documented.[148] Essentially, **credit derivatives are insurance products free from the protections of insurance regulation**. As such, they pose a grave threat to the American economy (not to mention bank depositors), and should be covered by the Volcker Rule's restrictions. For similar reasons, synthetic securities that derive their value from other assets or liabilities should also be considered "high risk."

As discussed in detail above, repurchase agreements and securities lending transactions can contain in-built proprietary positions. The structured varieties of these transactions are especially dangerous, because they are typically connected with very heavy leveraging, all the while being misconstrued for capital adequacy purposes as mere "secured loans."

Although securities issued by certain government-sponsored enterprises (GSEs) are exempted by Section 619, the Agencies should require a banking entity seeking to trade such securities to first file a transaction-specific application with the Federal Reserve to get pre-clearance based on an assessment of the risks involved in that transaction. High-risk mortgage purchases and guarantees by GSEs helped fuel the recent housing bubble and financial crisis.[149] The GSEs played a pernicious role in the recent economic crisis, and securities issued by these entities should not be given the same preference that is afforded to U.S. Government Treasury bonds. In September 2008, the U.S. Treasury placed Fannie Mae and Freddie Mac into conservatorship. Any securities issued by these enterprises have "bailout" written all over them.

For similar reasons, the Agencies should require an interpretive determination by the Federal Reserve before a banking entity is allowed to trade in municipal bonds. Even large municipalities have teetered on the verge of default in the past.[150] For instance, New York City

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[146] Proposed Rule § _.8(c)(1).
[147] *See* Abigail Field, *Lehman Report: The Business Decisions That Brought Lehman Down*, Daily Finance, Mar. 14, 2010. http://www.dailyfinance.com/2010/03/14/lehman-report-the-business-decisions-that-brought-lehman-down/.
[148] Jesse Eisinger, *The $58 Trillion Elephant in the Room*, Portfolio.com, Oct. 15. 2008. http://www.portfolio.com/views/columns/wall-street/2008/10/15/Credit-Derivatives-Role-in-Crash/.
[149] Dwight M. Jaffee, The Role of the GSEs and Housing Policy in the Financial Crisis (Feb. 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0227-Jaffee.pdf.
[150] Marilyn Cohen, *Municipal Bonds: Armageddon Or Opportunity?*, Forbes.com, Jan. 19, 2009, http://www.forbes.com/2009/01/17/municipal-bonds-bankruptcy-pf-in_mc_0119tmunibonds_inl.html.

almost defaulted on its debts in 1975. The same was true for Cleveland in 1978. Orange County, California famously filed for bankruptcy in 1994. The risk of default is exacerbated in smaller municipalities with fewer resources available to them as recourse. Issuances by small municipalities are also more susceptible to outright fraud. "JPMorgan Chase & Co. (JPM)'s Charles LeCroy said the key to landing bond deals in Jefferson County, Alabama, was finding out whom to pay off."[151] The exemption at § _.6(a)(ii) conveys the impression that bonds issued by the United States Treasury are considered as safe as bonds issued by even the smallest, remotest political subdivisions of States. Such is simply not the case.

We further recommend that the Agencies focus their attention on traditionally "low risk" assets as well, for a number of reasons. For one thing, "low risk" exposures are subject to lower capital reserves, which magnifies the potential fallout from unexpected defaults. Moreover, ostensibly "low risk" exposures end up being so designated across all banks that utilize similar risk-weighting methodologies. Correlations in pricing methodologies across banks thereby amplify the consequences of default. Indeed, the Agencies should apply the greatest scrutiny to exposures that are designated as "low risk" by third parties, such as rating agencies, especially where those parties have financial incentives to issue unduly favorable ratings.

The recent European sovereign debt crisis took even seasoned market observers by surprise.[152] **The fact is that virtually all assets can be "high-risk,"** especially if held in high concentration. In light of this economic reality, the Agencies should deem all trades to be *prima facie* "high-risk," and only allow Section 619(d) exemptions on a case-by-case basis, pursuant to a separate application by the concerned bank. Such an interpretation may be unpopular in the banking community, but the Agencies should be motivated by an objective assessment of the myriad holdings that can bring a bank to failure, and not by partisan pressure from the banking lobby.

The Proposed Rule makes insufficient use of CEO certifications as an enforcement tool. At present, CEO verification is only required within the contexts of certain prime brokerage transactions and the Volcker Rule's programmatic compliance regime. For any banking entity that relies on any exclusion from the general Volcker prohibition (e.g., market making, government securities, exempted funds, etc.), the Agencies should also require that the CEO specifically certify that the banking entity's activities do not result in a material exposure of the banking entity to high-risk assets or high-risk trading strategies, and further do not pose a threat to the financial stability of the banking entity or the United States. Although the limitations on high-risk activities are already embedded in the Rule, these provisions will actually benefit from real-world enforcement if CEOs are held personally accountable.

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[151] William Selway & Martin Z. Braun, *JPMorgan Proves Bond Deal Death in Jefferson County No Bar to New Business*, Bloomberg, Aug. 12, 2011, *available at* http://www.bloomberg.com/news/2011-08-12/jpmorgan-proves-bond-deal-death-in-jefferson-county-no-bar-to-new-business.html.

[152] *See* Amalia Estenssoro, *European Sovereign Debt Remains Largely a European Problem*, The Regional Economist (Federal Reserve Bank of St. Louis), Oct. 2010.

## C. High-Risk Trading Strategies

The Proposed Rule is ineffective because it does not properly define the term "high-risk trading strategy." This term is currently defined to include "a trading strategy that would, if engaged in by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail." The Agencies have failed to specify any trading strategies that are risky *per se*. Below, we describe several trading strategies that should fall within the definition.

### 1. Leverage Cap on Permitted Proprietary Trading

The Agencies should ban any proprietary trade that is permitted under a Section 619(d) exclusion if that trade is conducted through leverage that exceeds 3-to-1 debt-to-equity leverage. This also means that any "covered fund" must maintain a leverage ratio of 3-to-1 or less. We recognize that a 3-to-1 cap on leverage may be more restrictive that current banking standards in various contexts. Admittedly, the Market Risk Capital Rules, the upcoming implementation of Basel III, and various broker-dealer rules all impose less exacting leverage limitations on banks for what are currently-routine banking transactions. Even so, the Section 619(d) exemptions are not meant to allow banks to carry on "business as usual," and so the "usual" leverage standards need not apply in this context.

The Agencies must remain cognizant of the fact that the Section 619(d) exemptions are only meant for the most staid, basic, "plain vanilla" proprietary trades. "[T]he intent of section 619 is to restore the purpose of the Glass-Steagall barrier" and the exemptions to the basic ban on proprietary trading are only meant for "low-risk, client-oriented financial services."[153] The imposition of a 3-to-1 leverage would comport with the legislative mandate to require that any permitted exemptions be "low-risk." In fact, *if the Agencies decline to implement this recommendation, we would challenge them to demonstrate how the absence of any explicit leverage requirement in their Proposed Rule satisfies the legislative mandate for "low-risk."*

The role that leverage played in the recent financial crisis is well understood. In April 2004, the SEC voted unanimously to permit the largest broker-dealers to increase their leverage limits up to 30-to-1 or higher.[154] That decision has been identified as a major cause of the recent "Great Recession."[155] Bear Stearns and Lehman Brothers are conspicuous for their presence on this list of the SEC's "favorite sons."

The SEC and the other Agencies have been presented with an opportunity to undo the damage of that April 2004 decision. The Volcker Rule's "high-risk trading" backstop is an opportunity for the Agencies to impose explicit leverage limits on banking entities conducting exempted proprietary trading. One commentator has even argued that the imposition of appropriate

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[153] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).
[154] *See, e.g.*, Joseph E. Stiglitz, *Capitalist Fools*, Vanity Fair, Jan. 2009, *available at* http://www.forbes.com/2009/09/25/clinton-global-initiative-personal-finance-investing-ideas-bill-clinton.html.
[155] Alan S. Blinder, *Six Errors on the Path to the Financial Crisis*, N.Y. Times, Jan. 24, 2009, *available at* http://www.nytimes.com/2009/01/25/business/economy/25view.html.

leverage ratios would obviate much of the Volcker Rule's complexity.[156] The imposition of a 3-to-1, or some other prudent leverage limit would provide the markets with definitional certainty on a significant aspect of the Volcker Rule, and would help safeguard the fiscal health of the global economy.

### 2. Ban on Rehypothecation

One particularly nefarious trading strategy that should be banned in connection with permitted proprietary trading is the practice of rehypothecation. Rehypothecation occurs when banks borrow from third parties using collateral that is made up of securities or other assets that have been posted as collateral by the bank's client in a separate transaction. This practice is particularly dangerous because rehypothecations can occur in chains, such that the same collateral is reused multiple times in successive borrowings. The obvious problem is that the actual assets backing the borrowings never change, whereas the overall exposure is multiplied at each successive level. The amount of potential counterparty risk in these transactions is astonishing. For instance, the last creditor in a chain of five rehypothecations is reliant on the creditworthiness of six upstream entities. Worse still, the creditor may not be aware that the posted collateral has been churned in this fashion.

While there appear to be some limits on the practice of rehypothecation in the United States, American banks have found ways to evade these restrictions through regulatory arbitrage.[157] The United Kingdom does not effectively restrain the practice, and so American banks use foreign affiliates as conduits for rehypothecation. "Even without circumventing U.S. limits on rehypothecation, the off-balance sheet treatment means that the amount of leverage (gearing) and systemic risk created in the system by rehypothecation is staggering."[158] Moreover, there is speculation that this practice may have contributed to the loss of customer funds in the recent MF Global debacle.[159]

We are especially disconcerted by the fact that a significant amount of the "liquidity" that exists in the various markets may actually be little more than a House of Cards propped up by rehypothecations. The systemic risk of rehypothecations is not fully known because "financial stability assessments typically[] do not include pledged collateral, or the associated reuse of such assets."[160] Despite being little more than a hollow subterfuge, rehypothecations appear to be widespread:

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[156] *See* William R. Hambrecht, Making the Volcker Rule Work for America: A Pragmatic Alternative to Exemptions 1 (Nov. 9, 2011), http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2011/11/Bill-Hambrecht-Volcker-Rule-Paper-11-9-11.pdf.

[157] Christopher Elias, *MF Global and the Great Wall St Re-hypothecation Scandal*, Thomas Reuters News & Insight, Dec. 7, 2011. http://newsandinsight.thomsonreuters.com/Securities/Insight/2011/12_-_December/MF_Global_and_the_great_Wall_St_re-hypothecation_scandal/.

[158] *Id.*

[159] *Id.*

[160] Manmohan Singh, Velocity of Pledged Collateral: Analysis and Implications 18 (Nov. 2011) (IMF Working Paper), http://www.imf.org/external/pubs/ft/wp/2011/wp11256.pdf.

> Engaging in hyper-hypothecation have been Goldman Sachs ($28.17 billion re-hypothecated in 2011), Canadian Imperial Bank of Commerce (re-pledged $72 billion in client assets), Royal Bank of Canada (re-pledged $53.8 billion of $126.7 billion available for re-pledging), Oppenheimer Holdings ($15.3 million), Credit Suisse (CHF 332 billion), Knight Capital Group ($1.17 billion), Interactive Brokers ($14.5 billion), Wells Fargo ($19.6 billion), JP Morgan ($546.2 billion) and Morgan Stanley ($410 billion).[161]

Defining "high-risk trading strategy" to explicitly include rehypothecation is but a necessary first step. The Agencies should give serious thought to also tightening up other relevant regulations to account for the risks posed by this practice.

### 3. Limits on Concentration

The Agencies should ban any proprietary trade that is permitted under a Section 619(d) exclusion if that trade would result in the banking entity owning over 50% of the market capitalization or total outstanding value of any covered financial position. Banking entities that hold inordinately large concentrations of covered financial positions face nondiversification risk with respect to those holdings. In many circumstances, unfavorable market movements can debilitate a bank if its holdings are not diversified. The risk attendant to such nondiversification is ultimately borne by depositors and taxpayers, to their detriment. For instance, in May 2008, the OCC closed ANB Financial, NA, an Arkansas bank with $2.2 billion in total assets.[162] That bank failed partly because of gross under-diversification: 85% of ANB's funding came from brokered deposits.

Additionally, a bank retaining a controlling position in the outstanding interests of a covered financial position has an incentive to "bail out" the institution issuing the covered financial position if that institution faces economic difficulty. This incentivation compounds the risk to depositors and taxpayers from the bank's over-concentrated holding.

It should be noted that banks would continue to be able to conduct permitted underwriting despite this limitation. Such underwriting could be conducted in stages or with the participation of other underwriters in a syndicate. Incidentally, this type of staggered underwriting would promote optimal price discovery for the underwritten security, as the markets would be allowed more time to properly determine equilibrium pricing.

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[161] Tyler Durden, *The Denials Begin: Interactive Brokers Is First To Claim It Has Not Engaged In Commingling Rehypothecation*, Zero Hedge, Dec. 11, 2011, http://www.zerohedge.com/news/denials-begin-interactive-brokers-first-claim-it-has-not-engaged-commingling-rehypothecation.

[162] James W. Fuchs & Timothy A. Bosch, *Why Are Banks Failing?*, Central Banker (Federal Reserve Bank of St. Louis), Fall 2009, *available at* http://www.stlouisfed.org/publications/cb/articles/?id=1667.

### 4. Personal Trader Liability

None of the major investment banks currently operate as partnerships, but decades ago most did utilize that structure.[163] The largest banks now operate under the public company structure, which leads to a striking moral hazard in the manner in which these banks conduct trades. Since traders have no personal liability, there is little real downside to incurring monumental losses. Provided that no fraud occurs, the worst-case scenario for a trader who loses millions or billions of dollars of depositor-backed money is the loss of a job. Given that bank bonuses have continued unabated through the crisis, one might even imagine that such a trader would enjoy a lucrative bonus before heading off to a new job at a competing bank. The problem with this limited liability trading strategy is that it encourages speculation by traders, who face no real downside risk to playing with other people's money. The Agencies can ameliorate this situation by holding traders relying on a proprietary trading exemption to be personally liable for any losses. This requirement would be consistent with the legislative mandate that Section 619(d) permitted activities be safe and customer-oriented. Two law professors have proposed this very idea as an alternative to the arcane vicissitudes of the Proposed Rule.

> We cannot bring back the old investment banking partnerships, and most investment banks will continue to be public companies. We can, however, require the most highly paid executives in these firms to personally guarantee the debts of their firms in return for their high salaries and bonuses, or pay them with stock that is subject to a cash assessment if the firm gets into trouble and becomes insolvent.[164]

This personal liability does not need to be debilitating to an individual who mistakenly incurs losses in good faith. For instance, the Agencies can require that any trader relying on a Section 619(d) maintain something akin to a capital account that tracks gains or losses on traded positions. Any gains or losses from price movements would be itemized using the capital account, and any deficiencies in that account would be deducted from the trader's salary to the extent that the salary (including bonuses and expenses paid) is above $100,000. This way, traders would still enjoy financial "incentives" to work at prestigious banks, but would personally "feel the pinch" for their losses, instead of just outsourcing the pain to their customers, depositors or the American taxpayer, as is usually done.

This system will approximate the old partnership model of investment banks. In that model, bankers knew that their money was at stake so they took less risk. Unfortunately, the corporatization of these investment partnerships has led banks to concoct ever more complex instruments and other risky machinations in the manic pursuit of profit. The Agencies should utilize personal liability or a similar strategy to address trader moral hazard. The prohibition on high-risk trading strategies is but an after-thought in the Proposed Rule's current format, and the imposition of personal liability would make it robust.

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[163] Claire A. Hill & Richard W. Painter, *Another View: A Simpler Rein Than the Volcker Rule*, Oct. 28, 2011, *available at* http://dealbook.nytimes.com/2011/10/28/another-view-a-simpler-rein-than-the-volcker-rule/.
[164] *Id.*

### 5. Ban on High-Frequency Trading

The Proposed Rule elides regulating one of the most precarious trading strategies that exists today: high frequency trading ("HFT"). HFT has been recognized by international securities regulators as causative of the flash crash event of May 6, 2010.[165] HFT is primarily used for proprietary trading.[166] Even if banking entities provide HFT as a client service, it has no legitimate place in a prudent, risk-averse banking entity's trading arsenal. In passing Section 619, Congress's purpose was "refocusing the bank on its credit extension function"[167] and away from financial trading machinations. By abdicating trading decisions to computer algorithms, HFT subjects markets to wild, unchecked swings in volatility.

> [T]here is the risk that rogue algorithms, i.e., algorithms that malfunction and operate in an unintended way, may trigger a chain reaction and, in turbulent market conditions, withdraw liquidity from the market or impair orderly trading. Such risk is magnified when the speed of trading takes place at fractions of a second.[168]

From a practical standpoint, regulators have a very limited ability to redress the risks borne of HFT simply because of the speed with which these transactions are completed. Thus, we recommend that the Agencies impose a resting period on any order placed by a banking entity relying on a 619(d) exemption. For instance, this resting period could forbid a banking entity from buying and subsequently selling a covered financial position within the span of 2 seconds. Any banking entity placing orders in such a short time frame is not likely to be acting on behalf of a customer's best interest, but rather its own. A resting period requirement would also limit some of the wild volatility that the markets have seen in recent months, by reducing the risk of liquidity drought. A senior executive of the Bank of England has championed such a measure:

> While raising the average bid-ask spread, [a resting period requirement] might also lower [spread] variability at times of stress. Liquidity would on average be more expensive but also more resilient.[169]

A resting period has already been considered by European regulators, and their American counterparts should do the same.

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[165] Huw Jones, *Ultra Fast Trading Needs Curbs - Global Regulators*, Jul. 7, 2011, *available at* http://uk.reuters.com/article/2011/07/07/regulation-trading-idUKN1E7661BX20110707.

[166] Technical Committee of The International Organization Of Securities Commissions (OICU-IOSCO), *CR02/11, Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency* 21 (July 2011).

[167] 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[168] *Id.* at 29.

[169] Andrew G. Haldane, Executive Director, Financial Stability, Bank of England, Address at International Economic Association Sixteenth World Congress, Beijing, China 18 (July 8, 2011), http://www.bankofengland.co.uk/publications/speeches/2011/speech509.pdf.

## D. Conclusion

In summary, we recommend that the Agencies impose the following restrictions on banking entities relying on a Section 619(d) exemption. These restrictions derive their authority from the Section 619(d)(2) statutory limitations on the Section 619(d) exemptions.

1. Explicit limits on banking entity size, in order to minimize conflicts of interest;
2. Explicit limits on ownership of more than 50% of the market capitalization of a covered financial position;
3. Presumption that all assets are high-risk, which presumption may be overcome by a trade-specific application filed with the relevant Agency;
4. Explicit limits on the leverage (e.g., 3-to-1 or less) held by banks relying on a Section 619(d) exemption, in order to reduce exposure to high-risk assets;
5. Defining "risky assets" to include repurchase agreements, structured debt, assets in illiquid markets, and credit derivatives, *per se*;
6. Defining "high risk trading strategy" to include the practice of rehypothecation, *per se*, and to further require leverage caps, personal trader liability and concentration restrictions on banks relying on a Section 619(d) exemption;
7. Requiring banking entity CEOs to personally certify that the bank's activities do not result in a material exposure to high-risk assets or high-risk trading strategies, and further do not pose a threat to the financial stability of the banking entity or the United States.

The banking lobby will predictably remonstrate with an expansive interpretation of "high-risk asset" and "high-risk trading strategies" by arguing that this would reduce liquidity in the market. In assessing these remonstrations, the Agencies are reminded to abide by the legislative intent behind the Volcker Rule, which reaffirms that "it is irrelevant whether or not a firm provides market liquidity: high-risk assets and high-risk trading strategies are never permitted."[170]

[170] 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley).

## VII. ECONOMIC IMPACT OF SECTION 13

In their Cost and Benefits analysis, the Agencies suffer from what Keynes referred to as the "fetish of liquidity," that most "anti-social maxim of orthodox finance."[171] Instead of considering the Volcker Rule's impact on levels of employment, output or growth in all markets, the Agencies only focus their analysis on the potential impacts of the Rule on banks. The Proposed Rule gives scant mention to the precarious nature of proprietary trading, and the danger it has posed to global market health since the winnowing away of the Glass-Steagall Act.

Indeed, in its extensive Economic Impact analysis, the NPR glosses over the anticipated benefits of the Proposed Rule, and devotes disproportionate attention to the Rule's potential costs to banking entities. The Agencies' solicitude for the profitability of banking entities is undoubtedly heart-warming and encouraging to those entities, but is considerably less encouraging from the perspective of the general public.

### A. Benefits for Depositors

Many of the costs identified in the NPR occur in the form a zero-sum game, wherein a banking entity's "cost" serves as a benefit to depositors and the public in general.

The NPR notes that the Rule's restrictions may cause banking entities to lose profits from certain activities that may be on the borderline of proprietary trading. While empirical data on the point is limited, one might reasonably conclude that a positive correlation exists between risk to depositors on the one hand, and the degree to which a bank's trading activities are proprietary in nature on the other. Assuming such a correlation, a banking entity's avoidance of borderline-proprietary trading would be marginally beneficial to investors. Lost profits in such cases are not unintended "costs," but rather the crux of Section 619's intended regulatory effect. The Congressional intent behind Section 619 was to re-focus banks on customer-focused activities. An expansive interpretation of "proprietary trading" would reduce the risk of bank failure because only the most basic, customer-focused trades would make it through the Volcker Rule's gauntlet. This outcome would increase both depositor and investor confidence in banking entities, which in turn would increase real liquidity in the banking industry, and as a consequence, the overall market for credit. Increases in real liquidity would drive down real interest rates, improve consumption and help the global economy rebound from its currently depressed state.

The Economic Impact analysis is also deficient because it fails to include externalities in its discussion of the "costs" associated with bank compliance. Proprietary trading by a government-backstopped bank involves the distinct possibility of the bank needing to be bailed out, whether through depositors' funds, Federal Reserve financing, or taxpayer subsidies. The costs associated with these forms of bailout[172] must be included in the equation when considering the

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[171] John Maynard Keynes, *The General Theory of Employment, Interest and Money* 155 (1936).

[172] According to non-partisan government figures, the Federal Reserve loaned approximately $16 trillion to banks during the recent financial crisis. Phil Kuntz & Bob Ivry, *Fed Once-Secret Loan Crisis Data Compiled by*

economic impact of the Proposed Rule. To the extent that banks face costs from their compliance obligations or from lost proprietary trading profits, depositors and the public are concomitantly saved the externality costs of potential bailouts.

### B. Impact on Artificial Liquidity

The NPR extensively discusses the possibility that the Proposed Rule's restrictions on proprietary trading will cause reduced liquidity and expanded credit spreads, especially in currently illiquid markets.

First and foremost, the Congressional intent behind Section 619 is to re-orient banks towards stable, customer-focused activities. This necessarily involves a shift away from trading in risky, illiquid markets. It should be noted that the Proposed Rule does not prohibit proprietary trading by all entities. Rather, it focuses solely on government-backstopped banks that have access to easy money through the Federal Reserve and customer deposits. Thus, even if "banking entities" are precluded from making illiquid markets, those markets can continue to be underwritten by conventional investment banks. Thus, any supposed impact on overall liquidity or credit spreads is questionable.

Moreover, much of the so-called "liquidity" that the banks have engineered, especially in opaque OTC markets, can be most appropriately termed "artificial liquidity." As one commentator notes, the "very belief that the proliferation of financial derivatives and securitization techniques has enhanced global liquidity has been [the] core illusion driving the sub-prime bubble in the USA."[173]

Proprietary trading involves buying and selling purely for speculative reasons that have little to do with a true assessment of a financial position's underlying value. This creates inefficiencies in the market price of such positions. True price discovery is impeded by the hyper-liquidity that is introduced by speculative proprietary traders. This hyper-liquidity, motivated by nothing more than expectations of short-term price movements, creates inefficient subsidies to buyers and sellers in the market. Depositors and the Federal Reserve unwittingly pay for these subsidies by funding banks' trading activities.

The Agencies should recognize the fact that certain markets *should* feature large credit spreads, simply because they involve truly risky products. Market makers in illiquid markets often impede natural market forces by engaging in self-interested, rent-seeking trades that create artificially narrow spreads. Thus, a reduction in proprietary trading may have the effect of increasing spreads, but that is actually a systemic benefit, not a cost, because those wider spreads will more accurately reflect the risk involved in those positions. Free of the market obfuscation created by proprietary traders, investors would be able to more efficiently allocate capital.

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*Bloomberg Released to Public*, Bloomberg, Dec. 23, 2011, *available at* http://www.bloomberg.com/news/2011-12-23/fed-s-once-secret-data-compiled-by-bloomberg-released-to-public.html.

[173] Anastasia Nesvetailova, *Three Facets of Liquidity Illusion: Financial Innovation and the Credit Crunch*, 4 German Policy Studies 83, 94 (2008).

Hyper-liquidity may even paradoxically exacerbate market volatility. Liquidity that is propped up by banks for speculative reasons is apt to be withdrawn abruptly, when market conditions become disfavorable. This creates "liquidity black holes," which are "episodes in which the liquidity faced by a buyer or seller of a financial instrument virtually vanishes, reappearing again a few days or weeks later."[174] This disappearance and re-appearance of capital creates market volatility, which is anathema to investors and depositors alike. A stable market with moderate credit spreads would be a more salutary alternative to this scenario.

Even if illiquid markets were somehow debilitated by the Volcker Rule, there would likely be minimal impact on overall market efficiency and capital formation. **If banks are constrained in their ability to conduct legitimate market making, this will create market pressure for financial instruments to move to established exchanges and ECNs**, which empirical studies demonstrate to be relatively efficient and safe.[175] OTC markets typically feature inordinate levels of leverage that lead to non-Pareto optimal levels of default risk.[176] Indeed, as one commentator noted, "[i]t is surprising that banking authorities have not [explicitly] required banks to move [] derivatives market-making activity to a centralized exchange where transparency is enhanced and bank exposure to counterparty default risk is greatly reduced."[177] A reduction in the size of a dealer-made market would siphon investments into efficient, transparent and less-risky alternatives. The primary utility of illiquid instruments seems to be in generating lucrative fees for originators and market makers. The more "exotic" the instrument, the higher the potential for compensation for no reason other than that instrument's opacity.

### C. Benefits for Banking Entities and Investors

Many of the "costs" identified in the NPR are actually benefits to banking entities, investors and depositors. In fact, the banking industry as a whole has much to gain from strong enforcement of the Proposed Rule. The premier investment bank, Goldman Sachs, has acknowledged that a harsh interpretation of the Volcker Rule will actually boost banks' profitability:

> [Goldman Sachs Group Inc. Chief Financial Officer David] Viniar said on Wednesday that if regulators impose strict trading limits, Goldman would be forced to turn over assets more quickly, and would be more hesitant to buy securities from clients that it could not immediately sell. While the executive stopped short of saying Goldman would convert to an agency trading model—which matches buyers and sellers before executing a trade—he did indicate the

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[174] Avinash Persaud, *Liquidity Black Holes: What are they and how are they Generated* (Apr. 2003), http://www.g24.org/Workshops/pers0403.pdf.

[175] *See* Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. Chi. L. Rev. 219 (2009) ("[M]any large [financial institutions] act like markets in over-the-counter interest rate, currency and credit default swaps, and other more complex derivatives, being long and short similar contracts. This large degree of derivative exposure by [financial institutions] raises some serious questions and makes it all the more important to have strong board oversight of [their] derivative risk exposure.").

[176] Viral Acharya & Alberto Bisin, Centralized versus Over-The-Counter Markets, Mar. 16, 2010, http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/acharya_bisin_otc.pdf.

[177] *Id.* at n.104.

> bank would start buying securities at lower prices and selling them at higher prices to reflect the risk of taking on trades. Those wider 'bid-ask spreads' would make trading more expensive for clients, but help boost Goldman's returns.[178]

We implore the Agencies to give Goldman what it wants, in this respect.

A microeconomic analysis also demonstrates that harsh enforcement will benefit the banking industry. The banking industry is essentially an oligopoly[179], with only a handful of major players, especially vis-à-vis trading in illiquid markets. If a bank has to divest itself of proprietary trading units or hedge funds, that only serves to dilute risk across a greater number of entities, which in turn reduces the risk that any of those entities will be considered "Too Big to Fail." As the Agencies know, many of the premier banking entities are, at present, considered to be "Too Big to Fail." This creates a moral hazard in that those institutions are incentivized to undertake catastrophic risks because they enjoy an implied promise of impunity that can take the form of government bailouts, unfettered access to the discount window, easy financing via quantitative easing and other Federal Reserve policies. Strong enforcement will put pressure on banks to increase in number and reduce in size. Under classical economic theory, the most efficient markets are typically those having an almost infinite number of competitors, while the most inefficient ones are monopolies and oligopolies.[180] A competitive market will induce banking institutions to move away from the pursuit of exotic structured transactions simply for the purpose of reaping profits for themselves, and towards the offering of customer-focused banking services with less consolidation of risk. Investors will be protected through "free market regulation," in that their interests will be promoted simply as a consequence of natural market principles. In a competitive market, banks will have strong incentives *not* to engage in risky or conflicted transactions, because doing so could lose them future business. The absence of these negative factors could serve as a competitive advantage among competing firms. Exploited customers or depositors can "vote with their feet" and move their business to smaller, less risky banks. However, when there are only a handful of "sophisticated" banks for depositors and customers to choose from, opportunities for exploitation abound. In short, market efficiency will only be promoted if the Volcker Rule is vigorously enforced, and banking services are routed to smaller competitors as a consequence.

The NPR suggests that foreign banks may gain a competitive advantage because regulations like the Volcker Rule might not exist abroad. **This reasoning is predicated on the assumption that having the ability to decimate the world financial system through risky proprietary trading is a competitive advantage; it is not.** A strong implementation of the Volcker Rule would actually create a competitive advantage for American banks. Depositors and investors can be confident that their money is safe when dealing with a well-regulated, customer-focused bank. Conversely, these parties lose confidence where banks operate in a self-interested fashion, with

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[178] Lauren Tara LaCapra, *Goldman Looks on the Bright Side of Volcker Rule*, Reuters, Feb. 8, 2012, *available at* http://www.reuters.com/article/2012/02/08/us-goldman-volcker-idUSTRE8171UE20120208.
[179] Adam Davidson, *It's the Economy: The Wild West of Finance*, N.Y. Times, Dec. 7, 2011, *available at* http://www.nytimes.com/2011/12/11/magazine/adam-davidson-wild-west-of-finance.html ("There are nearly 8,000 banks in the United States, but the top 20 control more than 90 percent of the market.").
[180] *See* K. Jothi Sivagnanam, *Business Economics* 155-56 (2010).

few regulatory checks. Thus, American banking entities can only benefit from a Volcker Rule that "has teeth."

### D. Any Costs to Banking Entities are Justified

Section 619 was not passed with any additional funding allocated to the Agencies for actual enforcement. Thus, many of the costs associated with the Proposed Rule are being transferred to banking entities themselves, primarily in the form of recordkeeping and compliance obligations. This is an entirely appropriate outcome, especially given the fact that **much of the Rule's complexity is due to the banks' lobbying efforts.** The original Volcker Rule was not the 500-page behemoth it has become. The additional complexity exists as a direct consequence of the innumerable loopholes, exceptions and exemptions that the banks requested. This point was recently recognized by Representative Barney Frank, who informed the Agencies' heads during the recent House Financial Services Committee's hearing on the Volcker Rule that, "to some degree [banks] are complaining about you having accommodated them."[181] The banks now have what they wanted—an inordinately convoluted Rule—and must be required to pay for it.

Perhaps the most galling aspect of the banks' behavior in the last few years has been their inexorable insistence on issuing large-scale bonuses to their employees, despite sending the global economy into a tailspin. These banks have no compunction in borrowing 60-120% of the nation's GDP ($7.7 or $16 trillion dollars, depending on the estimate) from the Federal Reserve[182] on one hand, and contemporaneously issuing outlandish bonuses to executives, largely as rewards for highly speculative transactions.[183] If banks end up facing heightened costs from the Proposed Rule, they are free to defray such costs from compensation, and impose pay packages that are less outrageous in the extent to which they reward risky behavior. Similarly, the argument that the banks will not be able to hire and retain the best talent rings hollow when one considers the cataclysmic shift in banking that the Volcker Rule envisions. Banks must now conduct safe, "plain vanilla," customer-focused transactions. If the "best and brightest" eschew jobs that facilitate bank stability, then banks (not to mention depositors) are better off without that "talent."

The Agencies recognize that most banks have elaborate compliance structures already in place to address other rules and regulations. Even if such banks incur initial sunk costs in implementing

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[181] Mattingly & Hopkins, *supra* note 11.

[182] Bill McGuire, *Fed Loaned Banks Trillions in Bailout, Bloomberg Reports*, ABC News, Nov. 28, 2011. http://abcnews.go.com/blogs/business/2011/11/fed-gave-banks-trillions-in-bailout-bloomberg-reports/. By comparison, the entire inflation-adjusted GDP of the United States as of the last quarter was only $13.35 trillion. Timothy R. Homan, *Economy in U.S. Surpasses Pre-Recession Level After 15 Quarters*, Bloomberg Businessweek, Oct. 31, 2011, *available at* http://www.businessweek.com/news/2011-10-31/economy-in-u-s-surpasses-pre-recession-level-after-15-quarters.html. The $7.7 trillion figure may actually under-estimate the total amount loaned. A July 21, 2011 study by the Government Accountability Office indicated that the "total transaction amounts" for Federal Reserve lending actually totaled a staggering $16 trillion. U.S. Gov't Accountability Office, GAO-11-696, Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance Needed 131 (2011).

[183] Bank of America paid investment-banking employees bonuses of $4.4 billion, or an average of $400,000 per person. *See* David Mildenberg, *Bank of America Said to Pay Average Bonus of $400,000*, Bloomberg, Feb. 3, 2010, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aB9F9yg6310o.

the Proposed Rule's recordkeeping and compliance framework, over time the marginal costs associated with that framework should be minimal. Banks can utilize the "economies of scale" they already enjoy by virtue of existing compliance frameworks. In the long run, any costs placed on banking entities by a vigorously enforced Volcker Rule will pale in comparison to the benefits to be enjoyed by depositors and the general public. Indeed, the Office of the Comptroller of the Currency has estimated that, given extant compliance infrastructure, Volcker Rule record-keeping will only cost banks approximately $50 million a year. This amounts to a mere 0.3% of the estimated $15.8 billion that the top six American banks lost on proprietary trading in the recent crisis.[184]

The NPR notes that the Volcker Rule may stifle financial innovation, and cause the market for securitization and other structured products to dry up. However, the utility of these products is questionable in any case. One can hardly argue that capital markets were inefficient or illiquid before the burgeoning of esoteric financial products in the last 15 years. After all, the late 1990's saw a burst of real economic growth driven by technological innovation, which was in turn dependent on the ready availability of capital. Indeed, many well-informed people believe that securitizations and similar "innovations" have no productive value other than as a fee generation mechanism for financial companies. For example, in describing structured finance derivatives, President Bill Clinton has stated that "[w]e created all these new securities which have no value and create no jobs."[185] In his view, the markets as a whole would be better benefited by longer-term, less complex forms of capitalization.[186] Paul Volcker has expressed a similar sentiment with respect to exotic financial instruments: "I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth—one shred of evidence."[187] A similar view has also been espoused by Robert Kuttner, who has stated that:

> [i]t's time to simply abolish credit default swaps and similar exotic, impenetrable, essentially unregulated securities. They add nothing to economic efficiency, they line bankers' pockets, and they add massively to global financial risks. Swaps were only invented in the 1990s. The world got along beautifully—much better in fact—without them.[188]

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[184] *See* Editors. *Don't Give Up on the Sensible Ideas the Dodd-Frank Act Offers Banks: View*, Bloomberg View, Dec. 27, 2011, *available at* http://www.bloomberg.com/news/2011-12-28/don-t-give-up-on-the-sensible-ideas-the-dodd-frank-act-offers-banks-view.html.

[185] Robert Lenzner, *Clinton's Cure For Capitalism*, Forbes.com, Sep. 25, 2009, http://www.forbes.com/2009/09/25/clinton-global-initiative-personal-finance-investing-ideas-bill-clinton.html.

[186] *See id.*

[187] Interview with Satyajit Das, *The Financial Zoo: An Interview with Satyajit Das – Part I*, Naked Capitalism, Sep. 7, 2011, http://www.nakedcapitalism.com/2011/09/the-financial-zoo-an-interview-with-satyajit-das-%E2%80%93-part-i.html (last visited Nov. 12, 2011) ("US financial services increased its share of value added from 2% to 6.5% but is that a reflection of your financial innovation, or just a reflection of what you're paid?").

[188] Robert Kuttner, *Abolish Credit Default Swaps*, Huffington Post, http://www.huffingtonpost.com/mobileweb/2011/10/31/credit-default-swaps_n_1067152.html (last visited Nov. 11, 2011).

These viewpoints have empirical support. A comprehensive survey of empirical economic data has revealed little evidence for the existence of the financial innovation that is giddily extolled by financial institutions and their proponents.[189]

Financial innovation goes hand-in-hand with increased concentrations of risk and pricing opacity. The banking model has shifted away from "old-fashioned" prudential banking of the George Bailey variety, in favor of an "originate and distribute" model that revels in risk-taking. "[T]he banker today pays less attention to credit evaluation since the interest and principal on the loans originated will be repaid not to the bank itself, but to the final buyers of the collateralized assets."[190] From a Pareto-optimal, macroeconomic perspective, the markets would actually benefit if the Volcker Rule were to reduce "financial innovation" by government-backstopped banking entities.

Various commentators[191] have suggested that the Proposed Rule's restrictions on fund ownership would require banks to sell their assets under sub-optimal, "fire sale" conditions, especially in illiquid markets. However, these commentators overstate the Volcker Rule's impact on liquidity. For instance, junk bond trading volumes are at record levels, which has led one industry insider to opine:

> This rise in volume is a strong indication that brokerage houses were crying wolf about the reduced liquidity that was supposedly resulting from the anticipated implementation of the Volcker Rule.[192]

Moreover, the assumption behind the "fire-sale" argument seems to be that the Proposed Rule's implementation is imminent. In actuality, even after the Rule is implemented, banks can enjoy an automatic 2 year Conformance Period, followed by up to three 1 year extensions and/or a 5 year extension for illiquid funds. Allowing banks to conceivably hold assets until July 2022 is hardly indicative of a "fire sale" requirement. Indeed, most major banks have already shut down their proprietary trading desks,[193] well before the Proposed Rule has even gone into effect.

In summary, the Volcker Rule, if vigorously enforced, will re-orient banks towards conservative, customer-focused transactions. Even if major banks undergo significant costs in changing their business models to suit, those costs are required by Section 619 and are justified by the benefits to be had on a larger scale.

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[189] *See* W. Scott Frame & Lawrence J. White, *Empirical Studies of Financial Innovation: Lots of Talk, Little Action?*, 42 J. Econ. Lit. 1 (2004).

[190] Anastasia Nesvetailova. *The End Of A Great Illusion: Credit Crunch And Liquidity Meltdown* 16 (2008), http://www.diis.dk/graphics/publications/wp2008/wp2008-23_credit_crunch_and_liquidity_meltdown.pdf.

[191] *See* Dave Clarke & Joe Rauch. *Banks Seek to Avoid Volcker Rule "Fire Sale"*, Reuters. Dec. 7. 2011, *available at* http://www.reuters.com/article/2011/12/07/us-financial-regulation-volcker-idUSTRE7B60QZ20111207.

[192] Joseph Ciolli. *Junk-Bond Trading Rises to Most Since February: Credit Markets*, S.F. Chronicle. Jan. 26, 2012. *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/g/a/2012/01/26/bloomberg_articlesLYDHMY07SXKX01-LYF14.DTL&ao=all#ixzz1ktbQdhuz.

[193] *See, e.g.*, Maria Aspan, *Goldman Shutters Two Proprietary Trading Desks*, Reuters, Mar. 1, 2011, *available at* http://www.reuters.com/article/2011/03/01/goldmansachs-proptrading-idUSN0110849120110301.

## VIII. CONCLUSION

Many Americans stand at the threshold of an uncertain future. The Agencies involved in the Volcker rulemaking process have an historic opportunity to redress many of the economic wrongs of the past, and create a future that privileges the interests of the many rather than the few. We ask that you vigorously implement the considerable responsibilities that have been discharged to you by Congress, remain faithful to the statute's intent and consider the comments contained in this letter.

Thank you.

Sincerely,
/s/
**Occupy the SEC**

Akshat Tewary
Alexis Goldstein
Corley Miller
George Bailey
Caitlin Kline
Elizabeth K. Friedrich
Eric Taylor

# ANNEXURE A
# ANSWERS TO SPECIFIC QUESTIONS

**<u>Question 1</u>. Does the proposed effective date provide banking entities with sufficient time to prepare to comply with the prohibitions and restrictions on proprietary trading and covered fund activities and investments? If not, what other period of time is needed and why?**

In the recent past it has been far more common for America to need protection from her bankers than for the bankers to need protection from America. In light of the stunning financial fecklessness which inspired this legislation, a foundational principle of this document is that the investment banks—being as they are wealthy and profitable institutions enjoying implicit government guarantees—are in general not to be considered as sympathetic victims of onerous regulation, but rather as mischievous and often duplicitous profiteers who will, no doubt, seek to undermine, shirk, and otherwise evade the necessary provisions of this Rule.

The proposed effective date is "12 months after the date of issuance of final rules . . . or 2 years after the date of enactment of Section 13."[1] Given that many banks have already begun to institute the structural reforms (closing or spinning off proprietary activity, specifically) required by this rule, we feel this compliance period is more than generous.

In fact, as discussed below, we have serious concerns about the number and duration of extensions available to banking entities: if these exemptions are applied consecutively certain provisions of this Rule may not take effect for 10 years after the Rule is published—10 years in which certain systemic excesses will not be meaningfully curtailed. We understand that these extensions are noted in the statute and cannot be removed. Still, it is our strong recommendation that they be assessed concurrently, preventing any bank from gaining extensions longer than 5 (or 7, depending on interpretation) years.

**<u>Question 2</u>. Does the proposed effective date provide banking entities with sufficient time to implement the proposal's compliance program requirement? If not, what are the impediments to implementing specific elements of the compliance program and what would be a more effective time period for implementing each element and why?**

As per Question 1, it is our contention that the given timeframes are more than adequate. The majority of the compliance structures required by the Rule are either (in the case of reporting standards) already in place at banking entities or (in the case of winding down proprietary trading) already being prepared for.

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[1] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Proposed Rule, 76 Fed. Reg. 68,846, 68,848 (proposed Nov. 7, 2011) [hereinafter NPR or Proposed Rule].

**<u>Question 3</u>. Does the proposed effective date provide banking entities sufficient time to implement the proposal's reporting and recordkeeping requirements? If not, what are the impediments to implementing specific elements of the proposed reporting and recordkeeping requirements and what would be a more effective time period for implementing each element and why?**

As per Questions 1 and 2, we contend that the timeframes provided are entirely sufficient. The reporting and recordkeeping required by the Rule, broadly speaking, is reporting and recordkeeping already carried out by banking entities either for internal purposes or for compliance with other regulations. It should be no great burden on the banks to share this information with the relevant regulators.

Even if—as we propose below—broad new industry-wide reporting standards are introduced in conjunction with this rule, we feel that if these standards were instituted with the same alacrity banks typically show in their profit seeking the proposed timelines would be more than adequate.

**<u>Question 4</u>. Should the Agencies use a gradual, phased in approach to implement the statute rather than having the implementing rules become effective at one time? If so, what prohibitions and restrictions should be implemented first? Please explain.**

Were we under the impression that the statute was intended to effect a trivial goal—to mandate better signage in bank waiting areas, or licensing of receptionists—we might find some merit in the notion of a gradual implementation. It is our understanding, though, that this statute was passed as an urgent response to a major systemic failure, and that any delay in its full and aggressive implementation needlessly endangers the financial system and continues to place the world economy at the mercy of actors proven recently to be reckless and irresponsible.

**<u>Question 5</u>. Is the proposed rule's definition of banking entity effective? What alternative definitions might be more effective in light of the language and purpose of the statute?**

The current definition of banking entity is effective. The Volcker Rule appropriately requires that any affiliate that is not a permissible covered fund per the common rule be considered a banking entity subject to the Volcker Rule restrictions.

**<u>Question 6</u>. Are there any entities that should not be included within the definition of banking entity since their inclusion would not be consistent with the language or purpose of the statute or could otherwise produce unintended results?**

No. The Rule appropriately delineates the scope of covered banking entities. For further discussion, please see Question 5.

**Should a registered investment company be expressly excluded from the definition of banking entity?**

No. An exclusion for all registered investment companies is **not** warranted. To qualify for an exclusion the registered investment company must meet the standard defined in the rule:

SEC-registered investment companies that are controlled by a banking entity are not subject to the Volcker Rule if the banking entity only provides advisory or administrative services to, has certain limited investments in, or organizes, sponsors, and manages a mutual fund (which includes a registered investment company) in accordance with the Bank Holding Company Act ("BHC Act").[2] Thus, mutual funds already have a sufficient exclusion in the Rule, and an explicit exception from the definition of banking entity is unjustified.

**Why or why not?**

Moreover, it is not clear whether all registered investment companies will meet the standards defined in the rule (see directly above), and a blanket exemption from the banking entity definition would inappropriately broaden the scope of funds that are free of the Volcker Rule's restrictions. We believe that each company must be subject to falling within the definition of "banking entity," regardless of its registered investment company designation.

**Question 7. Is the proposed rule's exclusion of a covered fund that is organized, offered and held by a banking entity from the definition of banking entity effective? Should the definition of banking entity be modified to exclude any covered fund?**

*No.* The Proposed Rule would exclude from the definition of banking entity any fund that a banking entity may invest in or sponsor as permitted by the Proposed Rule. All funds should be subject to this test. If the Agencies create a blanket exemption for covered funds, such funds could be used as conduits for government-backstopped banking activities that include proprietary trading.

**Why or why not?**

A blanket exemption from the definition of "banking entity" for covered funds would have unintended consequences. A hedge fund, for example, could buy a bank as a wholly owned subsidiary, or buy a right to vote all shares of the bank. Under this exclusion the fund would not be a "banking entity" and could take whatever actions—including proprietary trading—it chose. As a parent company it could direct the subsidiary bank's funds in any number of ways through dividends or non-arms-length transactions.

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[2] *See, e.g.*, 12 U.S.C. §§ 1483(c)(6), (c)(8), (k); 12 C.F.R. §§ 225.28(b)(6), 225.86(b)(3) (2012).

**<u>Question 8</u>. Banking entities commonly structure their registered investment company relationships and investments such that the registered investment company is not considered an affiliate or subsidiary of the banking entity. Should a registered investment company be expressly excluded from the definition of banking entity? Why or why not?**

No, for reasons detailed in response to Question 6.

**<u>Question 9</u>. 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?**

No, for the reason stated above in Question 7. Under the potential exclusion presented here, an Asset Backed Security ("ABS") issuer could engage in banking in-house, and conduct ABS assembly and securities issuance as a secondary activity. With an ABS issuer exclusion, the ABS issuer could also conduct banking activities that could easily include proprietary trading. The ABS issuer would serve as a conduit for evasion from the Volcker Rule's restrictions. Moreover, there is already an exemption for securitization, so an additional carve-out from the definition of "banking entity" is unwarranted. The securitization exemption should be interpreted to only allow "loans" as mentioned in the statute at Section 13(g)(2). For further discussion, please see responses to Questions 230-231, and 296.

**<u>Question 10</u>. What would be the potential impact of including existing issuers of asset-backed securities in the proposed definition of "banking entity" on existing issuers of asset-backed securities and the securitization market generally? How many existing issuers of asset-backed securities might be included in the proposed definition of "banking entity"? Are there ways in which the proposed rule could be amended to mitigate or eliminate potential impact, if any, on existing asset-backed securities without compromising the intent of the statute?**

No. Section 619(g)(2) already contains protection for securitizations, so including existing issuers of asset-backed securities in the definition of "banking entity" would have no impact on such issuers. Further, the Final Rule must be *absolutely clear* about drawing bright-line distinctions between sponsoring banking entities and stand alone vehicles that are exempted under the Section 619(g)(2) rule of construction. Vagaries in the accounting rules treatment of "true sale" and bankruptcy remoteness must not be allowed to thwart the definitions in these rules. These issues are a carryover from the SIV and unconsolidated conduits problem that came to light during the 2007–08 crisis period.

**<u>Question 12</u>. If the ownership requirement under the proposed rule for credit risk retention (section 15G of the Exchange Act) combined with the control inherent in the position of servicer or investment manager means that more securitization vehicles would be considered affiliates of banking entities, would fewer banking entities be willing to (i) serve as the servicer or investment manager of securitization transactions and/or (ii) serve as the originator or securitizer (as defined in section 15G of the Exchange Act) of securitization transactions?**

No. Originating securitizations does not require short-term proprietary trading. For instance, in a traditional securitization, the sponsor bank will purchase the underlying receivables, allot them to the Special Purpose Vehicle ("SPV"), and then the SPV will issue securities using the receivables as collateral. The purchase/sale of the receivables will be a "riskless principal transaction" for a customer under § _.6(b). Even if the securitization vehicle is considered an "affiliate," it need not engage in proprietary trading to issue securities. There is no need for a separate exclusion.

**<u>Question 13</u>. 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?**

The Proposed Rule's definitions of buy and purchase and sale and sell are appropriate.

**<u>Question 14</u>. Is the proposed rule's definition of trading account effective? Is it over- or under-inclusive in this context? What alternative definition might be more effective in light of the language and purpose of the statute? How would such definition better identify the accounts that are intended to be covered by section 13 of the BHC Act?**

The Proposed Rule's definition of trading account is ineffective, because it is wildly under-inclusive of important trading activities as a result of several broad exclusions. Removing such exclusions would significantly strengthen the definition of trading account, and serve to realign the proposed rule with the intentions of the statute.

### 1. Exclusion of Repurchase and Reverse Repurchase Agreements

The Agencies must **remove § _.3(b)(2)(iii)(A) from the final rule**. The exclusion of repurchase and reverse repurchase agreements ("repos") from the definition of trading account is a violation of the statute. A vanilla repo, while economically a loan, can legally be a sale. Because the NPR's allowance is so wide as to allow unfettered trading of structured repos as well as vanilla

repos, the preamble's claim that repos are economically loans[3] does not justify the blanket allowance. There is no mention of repos in the statute, nor in the FSOC study, nor is its blanket exemption justified by mentions in the Congressional Record.

The exclusion of repos from the definition of trading account poses a dangerous threat to the financial stability of the United States. These risks have been underscored by Federal Reserve Chairman Ben Bernanke.[4]

We ask that the Agencies carefully consider the fact that repos could be used in a variety of ways to evade the rules and conduct proprietary trades through repos and reverse repos. As we will show in detail below,[5] evasive proprietary trading can be achieved through repos in order to conduct: Shorting, Basis Trades, Put Options, Interest Rate trades, Credit Default Swaps ("CDS"), and Total Return Swaps, among others.

If the Agencies will not remove the exclusion outright, we suggest that the Agencies instead reclassify repurchase and reverse repurchase agreements as permitted activities under § _.6, with the following requirements to qualify for the allowance:

1. The repurchase or reverse repurchase agreement must adhere to a publicly available, industry-standardized master agreement.
2. That the stated assets in the repurchase or reverse repurchase agreement consist only of high-quality liquid assets.

### 2. Exclusion of Securities Lending from the Definition of Trading Account

We suggest that the Agencies **remove** § _.3(b)(2)(iii)(B). If the Agencies will not remove the exclusion outright, we suggest that the Agencies instead reclassify securities borrowing and lending as permitted activities under § _.6, with the following requirements to qualify for the allowance:

1. The assets that the covered banking entity invests in using the proceeds of the securities lending transaction must be restricted to high-quality liquid assets, in order to minimize risk to clients.

### 3. Exclusion of Liquidity Management Programs

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[3] NPR at 68.862.

[4] Interview by Financial Crisis Inquiry Commission with Ben Bernanke, Chariman of the Federal Reserve at 21 (Nov. 17, 2009), *available at* http://www.scribd.com/doc/48878840/FCIC-Interview-with-Ben-Bernanke-Federal-Reserve.

[5] Please see our detailed answers to Questions 30-32 which outline all the legal issues with the NPR's interpretation of the statute, as well as the substantial potential for rule evasion through the use of repurchase and reverse repurchase agreements.

As with our suggestions for revisions to the repo and securities lending exclusions, we feel that incorporating an additional requirement into the liquidity management exclusion, that any assets "**consist only of high-quality liquid assets**," will strengthen the Rule and dampen the prospects for future evasion.

**Question 15. Is the proposed rule's approach for determining when a position falls within the definition of "trading account" for purposes of the proposed rule from when it must be reported in the "trading account" for purpose of filing the Call Report effective? What additional guidance could the Agencies provide on this distinction? Are there alternative approaches that would be more effective in light of the language and purpose of the statute? Is this approach workable for affiliates of bank holding companies that are not subject to the Federal banking agencies' market Risk Capital Rules (e.g., affiliated investment advisers)? If not, why not? Are affiliates of bank holding companies familiar with the concepts from the Market Risk Capital Rules that are being incorporated into the proposed rule? If not, what steps would an affiliate of a bank holding company have to take to become familiar with these concepts and what would be the costs and/or benefits of such actions? Is application of the trading account concept from the Federal banking agencies' Market Risk Capital Rules to affiliates of bank holding companies necessary to promote consistency and prevent regulatory arbitrage? Please explain.**

The trading account concept from the Federal banking agencies' Market Risk Capital Rules (MRCR) to affiliates of bank holding companies is a useful tool for defining "trading account" under the Volcker Rule. Even so, the Proposed Rule is effective to the extent that it avoids blindly following the MRCR standard in defining "trading account" under the Volcker Rule. We support the Proposed Rule's reference to the MRCR as one factor suggestive of a Volcker "trading account."

The danger in blindly adopting MRCR is that banks can add complexity and confusion to the designation, and thereby evade the short-term prohibitions contained in Section 619. Moreover, a separate review process is currently underway for the MRCR regulations, and the final MRCR rules will not be finalized before the comment period ends for the implementation. In fact, the MRCR rules may not be finalized before the effective date of the Volcker Rule. Any changes appearing in the Final MRCR would have a significant impact on the term "trading account" as defined in this Rule.

The definition of trading account for Volcker is both broader (accounts that qualify as investment accounts under MRCR would be included in the Volcker trading account "presumption" i.e., market-maker accounts), and narrower (securities underlying repos are trading accounts for MRCR, for example).

To be clear, we believe that MRCR principles can inform the Volcker trading account designation, but should not replace or supersede that designation. Any deviation by a banking entity from the MRCR definition of "trading account" would seem to require a positive justification. In fact, the Agencies should keep close track of differences in the way banking entities treat trading assets under the Volcker Rule, the MRCR, and the Call Report standards. The Agencies should mandate ongoing monitoring and disclosure of the components and exclusions of the banking entities' reported trading account assets. We propose that the following simplified disclosure report should be required to monitor and ensure compliance:

| Total Trading Account Assets under MRCR | Total Trading Account Assets under Volcker Rule | Differences | Trading Account Assets under Call Rpt Standard | Trading Account Assets under Volcker Rule | Differences |
|---|---|---|---|---|---|
| | | | | | |

This reconciliation report will provide a clear snapshot of the differences in treatment under the different standards. Any alternative approach to the definition should be based on actual risk assumed as the primary criterion rather than simply on intent.

Furthermore, the definition of "short-term" should be determined by asset class. Illiquid securities, for example, often have a long duration between purchase and sale, so the functional meaning of "short-term" in illiquid markets is much different than for securities in more liquid markets. A very illiquid security could still fall within a proprietary "trading account" even if it is meant for a "short-term" resale that is more than 60 days from purchase. For this reason, we recommend that the definition of "short-term" be deemed to vary by asset class.

**<u>Question 16</u>. Is the manner in which the Agencies intend to take into account, and substantially adopt, the approach used in the Market Risk Capital Rules and related concepts for determining whether a position is acquired with short-term trading intent effective?**

For further discussion, please see Question 15.

**<u>Question 19</u>. Is the exchange of variation margin as a potential indicator of short-term trading in derivative or commodity future transactions appropriate for the definition of trading account? How would this impact such transactions or the manner by which banking entities conduct such transactions? For instance, would banking entities seek to avoid the use of variation margin to avoid this rule? What are the costs and benefits of referring to the exchange of variation margin to determine if positions should be included in a banking entity's trading account? Please explain.**

The exchange of variation margin is a useful potential indicator of short-term trading in derivative or commodity future transactions. The exchange of variation margin is effectively equivalent to closing and re-entering an identical trade on a short-term basis. Therefore, long-term contracts that involve short-term exchanges of variation margin should be treated as short-term in determining the asset's trading account characteristics. The use of variation margin is an excellent way to differentiate true long-term contracts from short-term assets.

Issues might arise if variation margin was used as the only indicator of short-term trading. If it were the only indicator, restructuring to avoid margin would be an indication of abuse of the rules. Punitive damages should be defined for this evasion.

In addition, we recommend that the rules clarify that trading account activity be evaluated on a trade date basis.

**Question 21. Are there particular transactions or positions that are not included in the definition of trading account that should be? If so, what transactions or positions and why?**

Yes, positions arising from repurchase, reverse repurchase, and other "repo" transactions should not be excluded. Under the proposed MRCR, these positions qualify for trading account designation for purposes of calculating Capital rules.

It is difficult to argue that these transactions should be subject to capital charge treatment under the MRCR, while at the same time benefiting from an exclusion from the Volcker Rule restrictions.

**Question 23. Is the rebuttable presumption included in the proposed rule appropriate and effective?**

The rebuttable presumption is not effective. Any position bought/sold within 180 days should automatically be included, *per se*, in the trading account. This would not be a burdensome restriction as the bank can still avail itself of one of the numerous exceptions contained in the Rule.

Alternatively, the rebuttable presumption should be extended to 180 days. This would account for the fact that speculative positions in certain illiquid assets may be opened and closed in a greater-than-60-day timeframe. In addition, the Agencies should mandate ongoing monitoring and disclosure of all components, excluded or not, of the banking entities' reported trading account assets. We propose that the following simplified disclosure report should be required to monitor and ensure compliance:

| Total Trading Account Assets under MRCR | Total Trading Account Assets under Volcker Rule | Differences | Trading Account Assets under Call Rpt Standard | Trading Account Assets under Volcker Rule | Differences |
|---|---|---|---|---|---|
| | | | | | |

This reconciliation report will provide a clear snapshot of the differences in treatment under the different standards. Any alternative approach to the definition should be based on actual risk assumed as the primary criterion, rather than simply intent.

**Are there more effective ways in which to provide clarity regarding the determination of whether or not a position is included within the definition of trading account? If so, what are they?**

The core principle that all covered financial positions are presumed to be trading account assets is a powerful acknowledgement of Congressional intent. Simply put, rebutting this core principal should be difficult.

The criteria for rebutting the trading account presumption should be more onerous for banking entities. The current version is biased in favor of allowing the banking entity to rebut the presumption.

The demonstration criteria should be more restrictive. Documentation requirements should be clearly specified. Covered financial positions should be evaluated individually, not categorically. "Category" of covered financial position is undefined and should be stricken from the rebuttal eligibility.

The evidence required to demonstrate that the position was not acquired or taken principally for the purpose of short-term resale should clearly fit the criteria for which it qualifies. For instance, if a position is to be reconsidered as a trading asset, the rebuttal evidence should support the category it qualifies for (i.e., market making position).

Further, the term "short-term" should be replaced with the statutory "near-term," which we believe would encompass a wider range of covered financial positions.

**<u>Question 24</u>. Are records currently created and retained that could be used to demonstrate investment or other non-trading purposes in connection with rebutting the presumption in the proposed rule? If yes, please identify such records and explain when they are created and whether they would be useful in connection with a single transaction or a category of similar transactions. If no, we seek commenter input regarding the manner in which**

**banking entities might demonstrate investment or other non-trading intent. Should the Agencies require banking entities to make and keep records to demonstrate investment or non-trading intent with respect to their covered financial positions?**

The Agencies should require banking entities to make and keep records to demonstrate investment or non-trading intent. Challenges to the presumption should be made prohibitively expensive, particularly to minimize frivolous rebuttals and thereby reduce the burden on the administrative capacity of the Agencies. This can be accomplished by making the metrics and the documentation required to rebut exhaustive and costly.

**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 he arbitrage position is acquired or taken?**

All arbitrage positions should be presumed to be trading positions. Theoretically the profit should be locked in on the day the trade is entered. That would qualify the gains as short-term profit, even if it the positions are held long term.

**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.**

Short-term positions may be hidden in long-term accounts. Currently, proprietary trading is prohibited in "trading accounts." A "trading account" is an account that is "primarily" used for short-term gain. Any account that is "primarily" for long-term gain is therefore excluded. Short-term trades in a long-term account are therefore also exempted. The exposure associated with a short-term trade (in a long term account) could be huge. Accordingly, we recommend that all trading accounts, even long-term, should fall within the definition of "trading account" if any short-term position can possibly be taken therein. The Agencies have this authority: Section 619(h)(6) of the Dodd-Frank Act ("the Act") defines "trading account" as any account principally for selling in the near-term, "and any such other accounts as the appropriate Federal banking agencies . . . may . . . determine."

Please see the response to Question 14 for further discussion of this point.

**Question 26. Is the holding period referenced in the rebuttable presumption appropriate? If not, what holding period would be more appropriate, and why?**

No. The holding period defined in the rebuttal is inconsistent with the statute. A position purchased on Day T which is closed out on T+1 for settlement at some future date T+61, should

be considered trading even if the position continues to be held at the banking entity until settlement date.

**Question 27. Should the proposed rule include a rebuttable presumption regarding positions that are presumed not to be within the definition of trading account? If so, why, and what would the presumption be?**

No. That presumption exists already. It is implied in the Agencies' authority to designate additional "permitted activities" under Section 619(d)(1)(J). Moreover the Proposed Rule is already replete with loopholes, and an additional presumption against coverage would only serve to further dilute an already mottled Rule.

**Question 29. Do any of the activities currently engaged in by issuers of asset-backed securities that would be considered a banking entity constitute proprietary trading as defined by § __.3(b) of this rule proposal? Would any activities relating to investment of funds in accounts held by issuers of asset-backed securities (e.g., reserve accounts, prefunding accounts, reinvestment accounts, etc.) or the purchase and sale of securities as part of the management of a collateralized debt obligation portfolio be considered proprietary trading under the proposed rule?**

Yes, a banking entity's investment in accounts held by ABS issuers or the purchase and sale of securities in a Collateralized Debt Obligation ("CDO") portfolio could constitute proprietary trading. We recognize that banking entities can still conduct securitizations (as guaranteed by Section 619(g)(2)). Still, securitization does not require proprietary trading. Any purchases or sales required for "reinvestment" or "collateral management" can be done on a long-term basis. ABS are already opaque and difficult to price. Allowing proprietary trading on the underlying assets would a) put depositor funds at risk, and b) create adverse market risk for ABS investors, who may not be able to keep up with or understand quick changes in the underlying assets. Also please note that investment banks that do not have access to depositor funds can still structure ABS in which the SPV engages in proprietary trading (for "collateral management").

Creating a broad exemption from "banking entity" or "covered fund" for ABS issuers would allow banks to use SPVs for the purpose of conducting proprietary trading and not just for securitizing loans.

**What would be the potential impact of the prohibition on proprietary trading on the use of such accounts in (i) existing securitization transactions and (ii) future securitization transactions?**

Securitizations would continue, but the issuer (SPV) would engage in less proprietary trading, if it were sponsored by a banking entity. This would make securitizations a safer activity for banking entities to engage in.

This line of questions presumes that existing "securitizations" are benign, low-risk, and normal banking products. Under this reasoning Abacus, Squared, and every Magnetar-comparable securitization should not be inconveniently impacted and should be spared from any Volcker Rule effects.

**Would any of the securities typically acquired and retained using these accounts be considered an ownership interest in a covered fund under the proposed rule? Does the exclusion of trading in certain government obligations in § _.6(a) of the proposed rule mitigate the impact of the proposed rule on such issuers of asset-backed securities and their activities? Why or why not?**

Securities acquired and retained using these accounts could be considered ownership interests in covered funds, especially in the cases of consolidated SIVs and unconsolidated Conduits. There is a revived danger that excluding these from the banking entity designation would reauthorize many of the securitization abuses that led to the recent breakdown in the global financial system. Securitization needs to be **restricted** in this rulemaking.

**Question 30. Are the proposed clarifying exclusions for positions under certain repurchase and reverse repurchase arrangements and securities lending transactions over- or under-inclusive and could they have unintended consequences?**

The proposed clarifying exclusions are over-inclusive. They do not properly define the type of repos that qualify for the exclusion, and further do not limit the quality of the underlying collateral enough to warrant characterizing repo transactions as fundamentally low-risk secured funding. As we will show, repos can be structured in ways that would qualify them as trading assets, rather than as simply secured lending transactions.

The repo exclusion is also a violation of the statute. There is no mention of repos in the statute or in the Financial Stability Oversight Council ("FSOC") study. In fact, there is not a scintilla of support in the Congressional Record for the blanket repo exemption. In the Supplementary Information of the NPR, the Agencies state:

> 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.[6]

While we agree that "in economic substance" certain standard, non-structured repos with master agreement can behave like loans, legally repos are **not** loans. Legally, a repo is a *sale* with the right to repurchase. The Securities Industry and Financial Markets Association ("SIFMA") uses

[6] NPR at 68.862.

the term "Buy/Sell Back Transactions" in its Global Master Repurchase Agreement (2011 Version), which is a common agreement form for repo transactions.[7] Additionally, the CFTC's Division of Trading and Markets has stated that "the use of customer funds for the purchase of securities under reverse repurchase agreements, in accordance with the conditions set forth below, **will be treated as sales and buy-backs**."[8] Finally, repurchase agreements are **not treated as loans for the purposes of bankruptcy, regardless of their economic substance.** As pointed out by Michael Simkovic in The American Bankruptcy Law Journal:

> 2005 amendments to the Bankruptcy Code under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005142 ("BAPCPA"), effectively *rendered derivatives immune from recharacterization based on economic substance, even if the transactions transparently resemble loans*, as one [case, *Calyon New York Branch v. American Home Mortgage Corp.*[9]] recently confirmed. Prior to BAPCPA, the prospect that even a subset of exempt derivatives might be recharacterized based on economic substance, raised by a judicial decision which suggested that repos might be recharacterized as secured loans, 'sent shockwaves through the financial industry . . . [because it placed] billions of dollars in notional amounts of outstanding repos . . . in danger of being labeled as security interests.'[10]

Even by convention, a repurchase agreement is booked as a pair of standard purchase and sale transactions. Because repos are not **legally** loans, they would *not* be permitted through the language in 13(g)(2) of the BHC Act that allows for the sale of loans.

In addition, there are a myriad of possible repo structures, and many of the more complex forms of structured repos absolutely **do not** "in economic substance" behave like loans. As we will discuss at length below, a Total Return Swap is such a structure. By definition, a Total Return Swap is a repo. But in every economic sense, a Total Return Swap is a credit derivative, used to profit from the very "expected or anticipated movements in asset price" that the NPR Supplementary Information claims repos are not meant to capture.

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[7] SIFMA, Global Master Repurchase Agreement (2011), *available at* http://www.sifma.org/Services/Standard-Forms-and-Documentation/MRA.-GMRA.-MSLA-and-MSFTAs/Global-Master-Repurchase-Agreement---2011-Version/.

[8] CFTC Interpretative Ltr. 21, Use Of Customer Funds For The Purchase Of Securities Under Reverse Repurchase Agreements (Div. of Trading & Markets Aug. 30, 1993), *available at* http://www.cftc.gov/tm/finseginterp_2-1.htm.

[9] *In re American Home Mortgage, Inc.*, 379 BR. 503, 516-17 (Bankr. D. Del. 2008) ("The reference to 'repurchase and reverse repurchase transactions' is intended to eliminate any inquiry under section 555 and related provisions as to whether a repurchase or reverse repurchase transaction is a purchase and sale transaction or a secured financing. . . . Succinctly stated, if the definition of 'repurchase agreement' is met, the section 559 safe harbor provisions apply, period.").

[10] Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 Am. Bankr. L.J. 253 (2009) (emphasis added), *citing* Jeanne L. Schroeder, *A Repo Opera: How Criimi Mae Got Repos Backwards*, 76 Am. Bankr. L.J. 565, 567 (2002) (discussing *In re Criimi Mae, Inc.*, 251 B.R. 796 (Bankr. D. Md. 2000)).

Even if the Agencies insist that repos *are* legally loans, the repo exemption would still be in violation of Congressional intent. In the Congressional Record, Senator Merkley clarifies that:

> The definition of proprietary trading in paragraph (4) covers a wide range of financial instruments, including securities, commodities, futures, options, derivatives, and any similar financial instruments. Pursuant to the rule of construction in subsection (g), paragraph (2), the definition should not generally include loans sold in the process of securitizing; *however, it could include such loans if such loans become financial instruments traded to capture the change in their market value.*[11]

Structured repos like Total Return Swaps are a highly profitable business to the banking entities, and are absolutely used to "capture the change in their market value." Thus, repos as loans, and most importantly, structured repos, **are in no way authorized** by the BHC Act 13(g)(2).

In addition, this blanket exclusion of repos and reverse repos from the definition of trading account is in contradiction with the very motivation behind the Volcker Rule. If we look to the Congressional Record, we find that Senator Merkley points to arrangements like repos as the source of crashes:

> Over time, commercial and investment banks increasingly relied on *precarious short term funding sources*, while at the same time significantly increasing their leverage. It was as if our banks and securities firms, in competing against one another, were racecar drivers taking the curves ever more tightly and at ever faster speeds. Meanwhile, to match their short-term funding sources, commercial and investment banks drove into increasingly risky, short-term, and sometimes theoretically hedged, proprietary trading. When markets took unexpected turns, such as when Russia defaulted on its debt and when the U.S. mortgage-backed securities market collapsed, *liquidity evaporated, and financial firms became insolvent very rapidly.*[12]

Thus, we feel that the exclusions for repo and reverse repos are not authorized by the statute, and are in violation of Congressional intent. Thus, **the repo exclusion must be removed.**

Regarding unintended consequences, we recommend that the Agencies incorporate lessons learned concerning the role of repo in the MF Global bankruptcy, the Lehman Brothers collapse,

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[11] 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Levin) (emphases added).
[12] *Id.* at S5894 (statement of Sen. Merkley) (emphases added).

the findings of the Fed working group study on Tri-party repo[13], and the results of current litigation, most notably the J.P. Morgan/Sigma lawsuit[14], before finalizing a blanket exclusion for positions under certain agreements.

MF Global's recent implosion—replete with the apparently irretrievable loss of still-unknown amounts of customer money—offers an abject lesson. Reuters' article "MF Global proves Enron-era accounting lives on" describes MF Global's off-balance sheet "repo-to-maturity" arrangement:

> The firm offered billions of dollars in sovereign debt as collateral on a series of loans designed to expire at the same time as the collateral itself. With the collateral and the loans coming due simultaneously, MF Global might never take possession of that debt again. That entitled the firm to count those as sales, and moved $16.5 billion off its balance sheet, most of it debt from Italy, Spain, Belgium, Portugal and Ireland.
>
> …To top it all off, the accounting for these deals added $124 million in financing payments to the firm's revenue over the last four quarters, according to SEC filings, firm documents and people close to the firm.[15]

This case illustrates one of the principal problems with the Proposed Rule's interpretation of repos as secured loans: this interpretation fails to account for the fact that *repos often take on the characteristics of proprietary trading*.

The Agencies should carefully consider the fact that repos could be used in a variety of ways to evade the Rules and conduct proprietary trades through repos and reverse repos. We ask that the Agencies consider the following possibilities for how a banking entity may do so:

Shorting: A bank enters a reverse repo with Counterparty X using bonds as collateral. The bank immediately sells the bond, anticipating that the price of the bond will decline. When it is time to return the bonds to X, the bank buys them from the open market, hoping to benefit from price depreciation in the bond. This is essentially a short position on the bond, wrapped up in a repo.

Basis Trades: A bank enters a reverse repo with Counterparty X, using securities as collateral. Later, the bank (the repo lender) returns "substantially equivalent" securities instead of the original securities. Since the Proposed Rule uses the broadly-interpretable "stated asset" in the

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[13] Comment Letter from Viral Acharya, *A Case for Reforming the Repo Market*, to Tri-Party Repo Infrastructure Reform Task Force, *available at* http://www.newyorkfed.org/banking/NYU_ViralAcharya.pdf.
[14] *Bd. of Tr. of the Imperial County Employees' Ret. Sys. v. JPMorgan Chase Bank, N.A.*, No. 09 Civ. 3020 (S.D.N.Y. filed Mar. 27, 2009).
[15] Nanette Byrnes, *MF Global Proves Enron-era Accounting Lives on*, Reuters, Dec. 2, 2011, *available at* http://www.reuters.com/article/2011/12/02/us-mfglobal-accounting-idUSTRE7B124Z20111202.

definition of repo, it seems the Rule would allow the bank to return a "similar" asset instead of the original one. The bank is essentially going long the initial security it takes in as collateral, and short the "substantially equivalent" security that it will eventually return to Counterparty X.

Put Options: A bank repos some securities in exchange for cash. The repo lender takes the securities. Later, the repo lender fails to return the securities, either due to an outright default or pursuant to an embedded right to refuse delivery. The bank has essentially sold the securities. The CFTC has actually highlighted this possibility in a different context: "under new bank capital standards, a sale of securities subject to a repurchase agreement with a unilateral right in the transferee to refuse to return them could be construed to be the granting of a put from the perspective of the original 'seller.' This would attract a capital charge."[16]

Interest Rate Trades: A standard repo trade is a rates trade at its core, as the repo rate is effectively the interest on a collateralized loan. Booking a repo looks like three separate trades:

a. a sale of securities
b. a future purchase of the same securities, and
c. a swap, the cashflows of which are the repo rate.

The purchase and the sale of the securities net out, leaving a (proprietary) directional swap.

Credit Default Swaps: A bank wants to speculate on the failure of a Counterparty X, so it enters into a repo transaction with X with a significant haircut. The bank lends X some cash, and demands collateral with significantly higher value than the cash. If X defaults, the bank keeps the collateral and locks in a huge profit. (This is functionally a CLN with X, referencing X).

We also ask that the Agencies consider the ways in which structured repos contain, or can contain, elements of proprietary trading:

Cross Currency Repo: By accepting collateral denominated in a different currency than that of the cash exchanged for it, a bank can embed almost any desired FX exposure into a Repo.

Callable Repo: By including an early termination option for the repo lender, any repo swap can be made to include an option on that swap. If rates go up, the repo lender can exercise its option, recall the collateral, and re-repo at a higher rate.

Total Return Swap: A more generic way to structure a CDS into a repo, the repo rate in this structure is typically some spread to LIBOR, where the spread is determined primarily by the credit risk of the collateral at the time of the trade. In essence, the Bank is lending money in exchange for collateral **and** gaining exposure to the credit risk of the collateral. It is not difficult

[16] CFTC, *supra* note 8.

to see how banks can package almost any kind of risk into a repo by modifying the conditions of the "repo rate" within them.

We strongly urge the Agencies to consider how an unfettered repo exclusion could open the door to massive evasion of the Proposed Rule through clever structuring of repurchase and reverse repo agreements.

**Is there an alternative approach to these clarifying exclusions that would be more effective?**

We strongly suggest that § _.3(b)(2)(iii)(A) be removed from the Final Rule. Under § _.3(b)(2)(iii)(A), an account will not be deemed a trading account if it is used to acquire or take one or more covered financial positions that arise under a repurchase or reverse repurchase agreement. Such a blanket allowance can be used in the ways outlined above to successfully subvert the Rule and conduct proprietary trading. Any plain vanilla repos should easily classify for the liquidity management exclusion, thus there should be absolutely no need for a separate repo exclusion.

If the Agencies absolutely insist that repurchase and reverse repurchase agreements must be allowed to some capacity, then **repos must be reclassified from an exclusion into a permitted activity under § _.6**, so that it requires a compliance program, record keeping and reporting to the Agencies. Permitted activities are meant to specify when the prohibition on proprietary trading does not apply. Because a repo is a sale, as discussed above, and because even by convention a repurchase agreement is booked as a pair of standard purchase and sale transactions,[17] such an agreement would fall under the proprietary trading ban if not for the exclusion. Thus, it is logical and appropriate to reclassify repos as permitted activities, given that legally repos are sales. As we will discuss in our answer to Question 31, any permitted trading in repurchase or reverse repurchase agreements should adhere to the following criteria (which we have included in *Annexure B*):

1. That the repurchase or reverse repurchase agreement must adhere to a publicly available, industry-standard master agreement.
2. The stated assets in the repurchase or reverse repurchase agreement must consist only of high-quality liquid assets.

**Are the proposed clarifying exclusions broad enough to include <u>bona fide</u> arrangements that operate in economic substance as secured loans and are not based on expected or anticipated movements in asset prices?**

[17] A repo is typically booked as a three-legged trade: One leg is the sale, one leg is the future buy back, and the final leg is a swap, which reflects the repo rate.

The exclusion is entirely too broad, and will not only include far more than bona fide arrangements, but as written will also include repo agreements that are nothing more than subversive proprietary trading.

**Are there other types of arrangements, such as open dated repurchase arrangements, that should be excluded for clarity and, if so, how should the proposed rule be revised?**

Additional exclusions should **not** be granted, as the repo exclusion as written is already problematic, as we have discussed above.

**Alternatively, are the proposed clarifying exclusions narrow enough to not inadvertently exclude from coverage any similar arrangements or transactions that do not have these characteristics?**

We do not believe that the proposed clarifying exclusions are narrow enough, as we believe that structured repos are allowed by the NPR as currently written. We strongly suggest that the Agencies **remove the repo exclusion from the Final Rule**. Because repos can behave as proprietary trades, leaving such an exclusion effectively negates the entire purpose of the NPR, as unfettered proprietary trading activity may occur through a clever use of the repo exclusion.

If the Agencies will not remove the exclusion, please see our suggestions for how to narrow the repo allowances in *Annexure B*'s suggested addition to the Final Rule, § _.6(e).

Another topic the Agencies may want to consider for additional clarifying criteria are haircuts. Repo haircuts may at times reflect an expected or anticipated movement of the underlying collateral price during the life of the repo. Agencies may want to monitor repos that require haircuts (for reasons other than the creditworthiness of the counterparty) for a repo transaction that requires a haircut may be indicative of a low-quality asset.

**Question 31. Are repurchase and reverse repurchase arrangements and securities lending transactions sufficiently similar that they should be treated in the same way for purposes of the proposed rule?**

Repurchase and reverse repurchase agreements are **not** similar enough to securities lending to warrant identical treatment in the Final Rule.

**Are there aspects of repurchase and reverse repurchase arrangements or securities lending transactions that should be highlighted in considering the application of the proposed rule?**

The complexity of the legal definition[18] and economic behavior of repurchase and reverse repurchase agreements provide substantial potential for regulatory arbitrage. That is one of the many reasons why an elimination of the exclusion, or at a minimum, a far stricter definition (which we will outline below) of repurchase and reverse repurchase agreements, is required in the Final Rule.

**Do repurchase and reverse repurchase arrangements or securities lending transactions raise any additional or heightened concerns regarding risk? Please identify and explain how these concerns should be reflected in the proposed rule.**

Repos, reverse repos, and securities lending all carry significant risk. As Federal Reserve Chairman Ben Bernanke stated in his interview with the Financial Crisis Inquiry Commission:

> The investment banks relied on this repurchase agreement, overnight tri-party repo financing model. And this is when that model was really beginning to break down. And as the fear increased, the lenders, via the tri-party repo market and other short-term lending markets, again, began to demand larger and larger haircuts, premiums, which was making it more and more difficult for the financial firms to finance themselves and creating more and more liquidity pressure on them. And it was heading sort of to a black hole.[19]

Professor Viral Acharya of the Stern School of Business at NYU pointed out the problematic systemic risk that relying on financing through structured repos poses in his comment letter to the Tri-Party Repo Infrastructure Reform Task Force entitled "A Case for Reforming the Repo Market":

> [T]he liquidity risk that secured repo financing may become unavailable to a firm is inherently a systemic risk, materializing in states of the world where other financial firms are also experiencing stress and the markets for assets held predominantly by the financial sector are rendered illiquid.[20]

Former Treasury advisor Morgan Ricks has also pointed out the systemic risk inherent in short-term borrowings such as repurchase agreements:

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[18] *See* William W. Chip, *Are Repos Really Loans?*, Tax Notes (May 13, 2002), *available at* http://www.cov.com/files/Publication/60f595c5-6bb2-4a4e-8fe2-5378a84cd91a/Presentation/PublicationAttachment/c4755b62-a153-47bc-b341-84e08001da31/Are%20Repos%20Really%20Loans.pdf.

[19] Interview by Financial Crisis Inquiry Commission with Ben Bernanke, Chariman of the Federal Reserve, *supra* note 4.

[20] Acharya, *supra* note 13.

> Short-term borrowings are fragile. Like a weak immune system, these fragile borrowings turn otherwise manageable challenges into life-threatening situations. Our financial system can deal with the occasional boom and bust without much of a problem. What it can't handle—what sends the financial system and the economy into a tailspin—is a financial *panic*. And, by definition, a panic is about short-term IOUs.[21]

Given the ample evidence and widely held view that excessive structured repo lending poses systemic risk, we urge the Agencies to remove the blanket exemption for repurchase and reverse repurchase agreements provided by § _.3(b)(2)(iii)(A).

If the Agencies insist on allowances for repos in the Final Rule, instead of excluding accounts that trade repos from the definition of the trading account, the Agencies should instead explicitly include certain forms of vanilla, non-structured repo as permitted activities that requires a compliance program, record keeping and reporting to the Agencies. Thus, we suggest creating a new entry, § _.6(e) that allows **only** for repurchase and reverse repurchase agreements that adhere to a repo master agreement such as SIFMA's Global Master Repurchase Agreement (2011 Version). Please see our suggested language for § _.6(e) in *Annexure B*.

Please also see our answer above to Question 30, where we outline further risks of hiding proprietary trading within various flavors of repurchase and reverse repurchase agreements.

Finally, it is not clear to us what the Agencies' motivation is behind the repo and reverse repo exclusion, given the allowance for liquidity management in § .3(b)(2)(iii)(C) of the Proposed Rule. While the liquidity management exclusion defines five criteria that any liquidity management plan must meet to qualify, we believe a classic plain-vanilla repo agreement would certainly meet the liquidity management criteria. Thus, it appears to us that the Agencies are aware that the repo exclusion as currently written may include non-vanilla, structured repos, and this concerns us greatly. In order to prevent subversive proprietary trading hidden in repos, the Agencies should remove the exclusion altogether, as it should be redundant with the exclusion for liquidity management programs.

Securities lending transactions also raise additional concerns about risk. The first cause for concern is the opacity of the markets. Securities Lending occurs over-the-counter, and there are no regulations currently in place that require disclosures of shares loaned. As stated in the Financial Times:

> [m]any asset owners and managers lend out the shares they hold on behalf of investors, typically to hedge funds that want to sell short. They rarely disclose

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[21] Morgan Ricks, *A Former Treasury Adviser On How To Really Fix Wall Street*, The New Republic. Dec. 17, 2011. *available at* http://www.tnr.com/article/politics/98659/wall-street-term-out-panic.

> what shares are on loan, how much they make on the deal, or what they hold as security.[22]

The next cause for concern is that **securities lending can exploit investors**. In fact, securities lending may be a conflict of interest between the bank facilitating the securities lending business, and its institutional investors who are providing the assets to be loaned. As Larry Macdonald wrote in "Securities Lending: Cause Of The Next Financial Crisis?":

> [t]here is an expectation [that securities lenders'] focus should be on optimizing the value of their clients' holdings, yet the practice has side effects that appear to go against this duty.[23]

Another example of the risk, and conflict of interest, that securities lending may pose to investors is demonstrated in the class action lawsuit *Imperial County Employees Retirement System v JPMorgan Chase*. The class action complaint in that case points out that, "[a]ccording to the Securities Lending section of JPMorgan's website, the stated purpose for its Securities Lending Program is to 'obtain an attractive return while minimizing risk.'"[24] However, J.P. Morgan instead invested in medium-term notes (MTNs) issued by the structured investment vehicle Sigma Finance, Inc.[25] "[W]hile JP Morgan was investing the Plan's money in Sigma MTNs, JP Morgan also earned substantial fees and interest through providing short term repurchase agreements ('repo transactions') financing for Sigma," leading to a conflict of interest between JP Morgan's fiduciary responsibility to the Imperial County Employees Retirement Plan and its role as the financier to Sigma.[26] Finally, despite being in "a position to know of Sigma's problems . . . [r]ather than protect the assets of the Plan and the Class, JP Morgan supported Sigma with repo financing, then pulled the plug on this financing after its own money market funds received their final payments on their Sigma MTN holdings."[27]

As a final example of how securities lending can be run in an excessively risky way, consider the Congressional Oversight Committee's report from June 2010, which stated that collateral from AIG's securities lending was put into risky, profit-seeking investments:

> Rather than investing the cash collateral from borrowers in low-risk short-term securities in order to generate a modest yield, AIG invested in more speculative securities tied to the RMBS market. Consequently, these investments posed a

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[22] Chris Flood, *BlackRock Reacts to Securities Lending Criticisms*, Financial Times. Oct. 9. 2011. *available at* http://www.ft.com/intl/cms/s/0/3354514e-effc-11e0-bc9d-00144feab49a.html.
[23] Larry Macdonald, *Securities Lending: Cause Of The Next Financial Crisis?*, Investopedia.com, Oct. 26, 2009, http://www.investopedia.com/articles/stocks/09/securities-lending-concern.asp.
[24] *Imperial County*. No. 09 Civ. 3020 at ¶ 20.
[25] *Id.* at ¶ 7.
[26] *Id.* at ¶ 12.
[27] *Id.*

> duration mismatch (securities lending counterparties could demand a return of their collateral with very little notice) that was exacerbated by valuation losses and illiquidity in the mortgage markets that impaired AIG's ability to return cash to its securities lending counterparties.[28]

These actions led Marshall Huebner of Davis Polk & Wardwell, the law firm that represented FRBNY, to call AIG Financial Products' combination of outstanding CDS contracts and speculative securities lending a "double death spiral."[29]

Given the above-mentioned examples of conflict of interests that may appear in a securities lending program, as well as the systemic risks these programs can reap, we feel that it would hurt both investors and the financial stability of the United States to exclude securities lending from the definition of trading account. Thus, § _.3(b)(2)(iii)(B) must be removed from the final rule.

**<u>Question 32</u>. Are the proposed exclusions for repurchase and reverse repurchase arrangements and securities lending transactions appropriate or are there conditions that commenters believe would be appropriate as a pre-requisite to relying on these exclusions? Please identify such conditions and explain.**

We do **not** believe the exclusions are appropriate, as they can be used to evade restrictions on proprietary trading, as outlined in our answer to Question 30. We believe that there are certain conditions that should be met as a pre-requisite to relying on the repo exclusion:

1. The repurchase or reverse repurchase agreement must adhere to a publicly available, industry-standardized master agreement.
2. The stated assets in the repurchase or reverse repurchase agreement must consist only of high-quality liquid assets.

Further, if the Agencies insist on allowing repurchase and reverse repurchase agreements, these categories should be removed as an exclusion and instead be added as a new permitted activity in § _.6. We have outlined our suggested language—which takes into account the list of conditions above—in a new entry, § _.6(e), which may be found in *Annexure B*.

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[28] Congressional Oversight Panel, *June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy*, at 7. 271-72 (June 10, 2010), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT56698/html/CPRT-111JPRT56698.htm [hereinafter Congressional Oversight Panel, *June Oversight Report*].

[29] Congressional Oversight Panel, *The Final Report of the Congressional Oversight Panel,* at 131 n.398 (Mar. 16, 2011), *available at* http://cybercemetery.unt.edu/archive/cop/20110401232213/http://cop.senate.gov/documents/cop-031611-report.pdf [hereinafter Congressional Oversight Panel, *The Final Report*].

**Alternatively, we seek commenter input regarding why repurchase and reverse repurchase arrangements and securities lending transactions do not present the potential for abuse, namely, that a banking entity might attempt to improperly mischaracterize prohibited proprietary trading as activity that qualifies for the proposed exclusions.**

We **do** believe that repurchase and reverse repurchase arrangements present *incredible potential for abuse*, and that banking entities are very likely to attempt to improperly mischaracterize proprietary trading as repo or reverse repo agreements. Please see our examples of how a banking entity might do so in our answer to Question 30.

**Question 33. Is the proposed clarifying exclusion for liquidity management transactions effective and appropriate? If not, what alternative would be more effective and appropriate, and why? Is the proposed exclusion under- or over-inclusive? Does the proposed clarifying exclusion place sufficient limitations on liquidity management transactions to prevent abuse of the clarifying exclusion? If not, what additional limitations should be specified? Are any of the limitations contained in the proposed rule inappropriate or unnecessary? If so, how could such limitations be eliminated or altered in way that does not permit abuse of the clarifying exclusion?**

The proposed clarifying exclusion does not place limitations on liquidity management that are sufficient to prevent abuses and subversion of the Rule. In order to more effectively guard against abuse of this exclusion, we suggest that the Agencies change § _.3(b)(2)(iii)(C) as follows:[30]

> (2) Requires that any transaction contemplated and authorized by the plan be ~~principally~~ *solely* for ~~the purpose of managing the~~ *management of* liquidity of the covered banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;

The Agencies' usage of "principally for the purpose of" improperly dilutes the liquidity management exception. If the Agencies are to allow such an exception, they must require strict compliance, not "principal" compliance. Otherwise, banks would expressly be permitted to conduct openly proprietary trading activities within their liquidity management account, as long as such proprietary activities do not constitute a majority of the activities in that account.

Further, the Agencies should add a reasonableness requirement to § _.3(b)(2)(iii)(C)(3) to ensure that a bank's assumption of what constitute "highly liquid" positions taken for liquidity management purposes has some basis in reality. Otherwise, a bank could avoid all liability during an enforcement action by simply claiming that its proprietary positions, while objectively

[30] This and all suggested changes to the Rule text are also included in Annexure B.

speculative in nature, fall within the liquidity management exemption because the bank considered them "highly liquid" and did not expect to earn appreciable P&L on them at their inception. A subjective expectation is insufficient if it is unreasonable. At one time, Bear Stearns was highly liquid, as were the sovereign debts of Portugal, Italy, Ireland and Greece.

Finally, for the exclusion to be effective, "liquidity management" should be explicitly defined. It is vaguely defined in § _.3(b)(2)(iii)(C)(3) as taking a "highly liquid" position that the bank "does not expect to give rise to" significant P&L. That is why we suggest that the Agencies clarify this definition by making it more explicit, requiring that the "highly liquid," positions be more clearly defined. Failure to clearly define what a "highly liquid" position is will lead to subversion of the rule by way of the liquidity management exclusion.

We also recommend that the Agencies add § _.3(b)(2)(iii)(C)(6):

> (6) Requires that any transaction be conducted at a supervisory level at the banking entity and only with respect to aggregated positions, exposures or holdings.

**Question 41. Is the proposed liquidity management exclusion sufficiently clear? If not, why is the exclusion unclear and how should the Agencies clarify the terms of this exclusion?**

Please see our suggested revisions to the liquidity management exclusion as described in Question 33.

**Question 42. Is the proposed clarifying exclusion for certain positions taken by derivatives clearing organizations and clearing agencies effective and appropriate? If not, what alternative would be more effective and appropriate, and why?**

The exclusion for positions taken for registered derivatives clearing organizations or clearing agencies is appropriate. For the sake of clarity, we suggest adding the word "clearing" before the words "securities transactions" to make it absolutely clear that the exclusion is not permitting any securities transactions unless they are directly related to the clearing of such securities. The term "in connection with" clearing derivatives and securities suggests that the only permissible covered positions are the positions that the institution is clearing for its customers. This exclusion therefore would only cover uncleared trades. The Agencies should clarify what covered positions "connected with" clearing qualify for the exclusion.

**Question 43. Are any additional clarifying exclusions warranted? If so, what clarifying exclusion, and why?**

No further exclusions are warranted, and we would urge the Agencies to push back on any

additional exclusions, given that even the existing exclusions open up potential loopholes for rule evasion (as we have outlined in Question 30).

**Question 44. Should the proposed definition exclude any position the market risk of which cannot be hedged by the banking entity in a two-way market?[116]**
**If so, what would be the basis for concluding that such positions are clearly not within the statutory definition of trading account?**

We strongly oppose the suggestion that any position that cannot be hedged in a two-way market be excluded from the proposed definition of covered position, or that any account with such positions be excluded from the definition of "trading account."

Illiquid assets present *more* adverse market risk than other assets, and thus are more likely to lead to conditions that would require depositor bailouts. An illiquid exclusion could exempt entire trading desks that deal with less liquid securities (such as emerging markets or leveraged finance) from regulation, and could incentivize market makers to misrepresent the liquidity of certain assets such that they fall outside of regulation. For example, a bond approaching default will lose liquidity as it gains risk; thus, Greek sovereign bonds are extremely illiquid and would now be outside of the scope of regulation, despite obvious and extreme risks. Although such positions are already excluded from the most recent proposed revisions to the Market Risk Capital Rules (as pointed out in footnote 116 of the NPR),[31] this fact is hardly an effective argument that the NPR should *also* exclude them. If anything, the fact that the Market Risk Capital Rules do not cover such illiquid assets makes it absolutely **imperative** that the final version of this Rule expressly includes all assets, liquid or illiquid. Please see Question 85 for extensive further discussion of the risks of illiquid products.

**Question 45. Should the proposed definition include a clarifying exclusion for any position in illiquid assets? If so, what would be the basis for concluding that such positions are clearly not within the statutory definition of trading account? How should "illiquid assets" be defined for these purposes? Should the definition be consistent with the definition given that term in the Board's Conformance Rule under section 13 of the BHC Act (12 CFR 225.180 et seq.)?[117]**

The proposed definition should absolutely **not** include a clarifying exclusion for any position in illiquid assets. The Congressional Record shows that the intention of the Volcker Rule was to "prohibit high-risk proprietary trading at banks,"[32] and we can think of no riskier type of proprietary trading than that in illiquid assets.

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[31] Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890, 1912 (proposed Jan. 11, 2011) (excluding from the definition of a covered position any position the material risk elements of which the holder is unable to hedge in a two-way market).
[32] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).

While the statute does provide for an up to five year extension that may be granted by the Board[33] for a banking entity to divest from an "illiquid fund," the statute makes **no special allowances** for illiquid assets as they relate to the trading account. As stated in Question 44, illiquid assets present *more* adverse market risk than other assets, and thus are more likely to lead to conditions that would require depositor bailouts.

Illiquid assets also raise significant risks for investors, because illiquid assets by nature are both difficult to accurately price, and thus difficult to sell. Even if the banking entity is dealing with a highly sophisticated investor, the risks of illiquid assets do not outweigh their benefits, and we cannot fathom a legitimate reason why the Agencies would provide an exclusion for illiquid assets. Such an exclusion would only serve to undermine the very intent of the rulemaking.

Please see Question 85 for further discussion on the risks of illiquid products.

**<u>Question 46</u>. Is the proposed rule's definition of covered financial position effective? Is the definition over- or under-inclusive? What alternative approaches might be more effective in light of the language and purpose of section 13 of the BHC Act, and why?**

The Proposed Rule's definition of "covered financial position" is imprecise in its delineation of "loans," which are excluded from the scope of the Volcker Rule.[34] The current definition implies that securities, derivatives, and commodity futures are not considered loans. However, this distinction should be made explicit, so that the Proposed Rule makes crystal-clear that any "loan" with the properties of a commodity[35] or security would qualify as a covered financial position. We propose that the definition of loan at § _.2(q) be modified to read as follows:

> (q) Loan means any loan, lease, extension of credit, or secured or unsecured receivable. *A loan shall not mean a position:*
>
> 1. *having the expectation of profits arising from a common enterprise which depends solely on the efforts of a promoter or third party,*[36]
> 2. *in which there is common trading for speculation or investment,*[37]
> 3. *that materially has the characteristics of a commodity, security, or derivative, or*
> 4. *that falls within the scope of § _.3(b)(3)(i)*

[33] 12 U.S.C. § 1851(c)(3)(B) (2011).
[34] Proposed Rule § _.3(b)(3)(ii)(A).
[35] As discussed below, commodities should be included as covered financial positions.
[36] This language derives from *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293 (1946).
[37] This language derives from *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990).

While there is overlap in some of these definitions, such overlap will be practically useful as it will reinforce to reviewing courts, the Agencies and compliance officers the bounds of what is and is not covered by the Volcker Rule.

For instance, one law firm has suggested that the current version of the Proposed Rule would not restrict a banking entity's ability to use an "intercompany loan" as a means to approximate an "ownership interest" in a securitization SPV.[38] That is, the Volcker Rule's restrictions on "ownership interest" can be evaded by structuring an interest in an SPV as an intercompany "loan" and not ownership *per se*.

In a more straightforward securitization, the banking entity has an ownership interest in the SPV, and therefore gains risk exposure to the asset pool underlying the transaction. The same result can be achieved by using an intercompany loan, such that the bank loans money to the SPV, and is repaid its money by the SPV based only on the performance of the underlying asset pool.[39] In either scenario, the banking entity's income stream is dependent on the timely and regular flow of funds from the underlying assets. However, the latter structure, ostensibly a "loan," would fall outside the purview of the Proposed Rule in its current form. Our proposed modification at § _.2(q)(1) or (2) would foreclose a banking entity's ability to evade the Volcker Rule's restrictions by using so-called loans as conduits for proprietary positions.

Further, the Proposed Rule in its current form could allow banking entities to engage in active trading of unpooled, large-scale commercial loans for purely speculative purposes. Our revised definition at § _.2(q)(2) would make any financial position that is actively traded for speculation or investment a covered financial position, even if that position is nominally designated as a "loan."

**<u>Question 47</u>. Are there definitions in other rules or regulations that might inform the proposed definition of covered financial position? If so, what rule or regulation? How should that approach be incorporated into the proposed definition? Why would that approach be more appropriate?**

For further discussion, please see Question 50.

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[38] Allen & Overy, What's in a Name? The Volcker Rule's Impact on ABS Issuers that are Covered Funds. Nov. 17, 2011. http://clientlink.allenovery.com/images/What%27s_in_a_Name_The_Volcker_Rule%27s_Impact_on_ABS_Issuers_that_are_Covered_Funds.pdf (last visited Jan. 2, 2012).

[39] *See* Vinod Kothari. Covered Bonds in Asia 9-10 (1st ed. 2006), *available at* http://www.vinodkothari.com/Covered%20Bonds%20in%20Asia.pdf. In such a structure, the loan repayment obligations of the banking entity can be tailored to match the debt profile in the SPV's asset-backed securities. *See* Vinod Kothari, Securitization: The Financial Instrument of the Future 348 (1st ed. 2006).

**<u>Question 49</u>. The proposal would apply to long, short, synthetic, or other positions in one of the listed categories of financial instruments. Does this language adequately describe the type of positions that are intended to fall within the proposed definition of covered financial position? If not, why not? Are there different or additional concepts that should be specified in this context? Please explain.**

The Agencies should promote greater definitional identity between the concept of "covered financial position" in the Volcker Rule and the "covered position" standard used in the Market Risk Capital Rule. At present, the two standards are "similar," but remain materially dissimilar in significant ways (For further discussion, please see Question 50). The Proposed Rule does not explain why the same standard is not utilized in both contexts.

**<u>Question 50</u>. Should the Agencies expand the scope of covered financial positions to include other transactions, such as spot commodities or foreign exchange or currency, or certain subsets of transaction (e.g., spot commodities or foreign exchange or currency traded on a high-frequency basis)? If so, which instruments and why?**

The Proposed Rule's exclusion of commodities from covered financial positions is troubling. The statute defines proprietary trading to include transactions in:

> any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.[40]

Admittedly, Section 619(h)(4) does not explicitly include spot commodities, instead referring to commodity futures and forwards. Nevertheless, the same section grants the Agencies the authority to bring commodities into the Volcker Rule's ambit. The Agencies should utilize this authority as it appears that the exclusion of the word "commodity" from the statute was an oversight. In the Congressional Record, Senator Merkley stated that the intent behind Section 619 was to define proprietary trading to cover "**a wide range** of financial instruments, including securities, **commodities**, futures, options, derivatives, and **any similar financial instruments**."[41] The expansive breadth of this language also militates in favor of the inclusion of foreign exchange and currency positions. Accordingly, we recommend that the Agencies entirely remove Proposed Rule § _.3(b)(3)(ii)(B) and (C).

This removal is also necessary because the definition of "covered financial position" under the Volcker Rule does not match the definition of "covered position" under the Market Risk Capital

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[40] 12 U.S.C. § 1851(h)(4).
[41] 156 Cong. Rec. S5895 (daily ed. July 15. 2010) (statement of Sen. Levin)(emphases added).

Rule, which explicitly includes all positions in a trading account, "and all foreign exchange and commodity positions, whether or not they are in the trading account."[42] As noted elsewhere in the Proposed Rule, the Market Risk Capital Rules have a high degree of relevance as to what is and is not covered by the Volcker Rule, specifically with respect to the definition of "trading account." Thus, the Agencies create undue ambiguity by imposing two different standards in related rules. A decision by an administrative agency that is based on a rationale that is internally inconsistent or incoherent will be set aside.[43]

**Question 51. What factors should the Agencies consider in deciding whether to extend the scope of the proprietary trading restriction to other financial instruments under the authority granted in section 13(h)(4) of the BHC Act?**

Proprietary trading strategies can be used with virtually any financial instrument, and abusive practices will migrate to under-regulated markets as banking entities respond to the new incentives created by the Volcker Rule. This migration could cause serious disruptions to previously well-functioning markets. Thus, we recommend that the Agencies broaden the scope of covered financial positions, as described here, in order to retain visibility over new and currently-underutilized asset classes that can become conduits for proprietary trading.

**Question 60. Is the manner in which the proposed definition of derivative excludes any transaction that the CFTC or SEC exclude by joint regulation, interpretation, guidance, or other action from the definition of "swap" or "security-based swap" effective? If not, what alternative approach would be more appropriate? Should such exclusions be restated in the proposed rule's definition? If so, why?**

The Proposed Rule references standards (definitions of "swap" or "security-based swap") that themselves are still at the proposed rule stage under a separate notice of rulemaking. The final version of these definitions may have additional exclusions that we are not aware of at this time. Thus, the public may not have an adequate opportunity to respond to material aspects of this Proposed Rule if the final definitions of "swap" or "security-based swap" are different from what has already been proposed. We recommend that the Agencies state the exact language of these terms in this Proposed Rule rather than referring to inchoate definitions from a separate proposed rule.

**Question 61. Is the proposed rule's definition of loan appropriate? If not, what alternative definition would be more appropriate? Should the definition of "loan" exclude a security? Should other types of traditional banking products be included in the definition of "loan"? If so, why?**

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[42] Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. at 1892.

[43] *Motor Vehicles Mfgs. Ass'n v. State Farm Mutual Auto Ins. Co.*, 463 U.S. 29, 43 (1983) (requiring agencies to show a rational connection between the facts found and the choice made).

For further discussion, please see Question 46.

**<u>Question 65</u>. Are the seven requirements included in the underwriting exemption effective? Is the application of each requirement to potential transactions sufficiently clear? Should any of the requirements be changed or eliminated? Should other requirements be added in order to better provide an exemption that is not susceptible to abuse through the taking of speculative, proprietary positions in the context of, or mischaracterized as, underwriting? Alternatively, are any of the proposed requirements inappropriately restrictive in that they would be inconsistent with the statutory exemption for certain underwriting activities? If so, how?**

The Agencies have transgressed their delegated authority by allowing the underwriting exemption in the Volcker Rule to include private placements. Section 619(d)(1)(B) permits certain "underwriting . . . activities." Not coincidentally, this section is bereft of any mention of "private placement activities" or "placement agent." In issuing implementing regulations, an administrative agency must give effect to the unambiguously expressed intent of Congress.[44]

Under the basic securities law definition of the term, an "underwriter" includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security."[45] Such a person is required to file a registration statement before offering to sell a security as part of a primary distribution.[46] Conversely, if a person is legally exempt from the registration statement requirement, that person cannot be an "underwriter" under Section 2(a)(11) of the Securities Act of 1933 ("'33 Act"). For example, a placement agent relying on the Rule 144 exemption is not considered an "underwriter."[47] Thus, the Section 2(a)(11) definition of underwriter would require that any underwriting activities permitted under the Volcker Rule be in connection with regulated securities.

Much to our chagrin, the Agencies have found a way to bypass this basic stricture. In defining the term "underwriter" in the Proposed Rule, the Agencies curiously rely on the definition of that term in Regulation M, instead of the more obvious and basic definition found at Section 2(a)(11) of the '33 Act.[48] Section 2(a)(11) has close to a century of case law and interpretive guidance

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[44] *Chevron U.S.A. Ins. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984).
[45] 15 U.S.C. § 80b-2(a)(11) (2011).
[46] 15 U.S.C. § 80b-4(1), 5(c).
[47] Preliminary Note to Rule 144. 17 C.F.R. § 230.144 (2012).
[48] *Compare* 17 C.F.R. § 242.100 (2011) (Regulation M definition) ("Underwriter means a person who has agreed with an issuer or selling security holder: (1) to purchase securities for distribution; or (2) to distribute securities for or on behalf of such issuer or selling security holder; or (3) to manage or supervise a distribution of securities for or on behalf of such issuer or selling security holder."). *with* 15 U.S.C.. § 77b(11) (2011) (Section 2(a)(11) definition of underwriter) ("The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security. or participates or has a direct or

supporting it, and it is therefore more appropriate than the Regulation M definition. Further, as noted above, nothing in Section 619 or the Congressional Record suggests that Congress wanted "underwriter" to be defined as per Regulation M. Moreover, Regulation M is not a good definitional source because the underlying purpose behind it conflicts with the underlying purpose behind the Volcker Rule. Regulation M was designed to prevent manipulation and other activities that could artificially influence the market for an offered security.[49] Thus, a broad interpretation of the term "underwriter" was naturally necessary in that context to promote greater investor protection and market stability. However, using the same broad interpretation of "underwriter" in the context of Section 619 would actually undermine investor protection, as it would increase the size of the underwriting loophole through which covered banking entities could conduct risky proprietary trading activities.

The underwriting exemption should also explicitly exclude private placement for a very practical reason: *allowing underwriting in private placements would be tantamount to allowing any and all proprietary trading in opaque OTC instruments.* OTC markets are generally very illiquid, with few parties willing to buy or sell a particular offering. The Agencies' current interpretation of "customer" is extremely expansive, and includes virtually all counterparties, whether pre-existing customers or not. Thus, any banking entity that purchases a position in an OTC instrument from any counterparty could call itself an "underwriter," under the guise that it intends to later distribute the instrument to other "customers." Even if the banking entity intends to purchase an OTC instrument for purely speculative purposes, it can justify holding that instrument in its inventory under the rationale that no buyers are available because the market is illiquid. This result would render moot the Volcker Rule's restrictions on the riskiest proprietary positions. Instead of conducting safe, traditional, customer-focused underwriting, banking entities would be enabled to continue with their "Originate and Distribute" model, whereby esoteric securities are fashioned from thin air, and "underwritten" solely for fee generation purposes and **not** to promote liquidity in non-financial markets.

In light of the above, we recommend the following changes to the Proposed Rule:

> § _.4(a)(2)(ii): The covered financial position is a **registered** security;
> § _.4(a)(3): Definition of distribution. For purposes of paragraph (a) of this section, a distribution of securities means an offering of securities~~, whether or not subject to registration under the Securities Act,~~ that is distinguished from ordinary

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indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.").

[49] FINRA, *Regulation M Filings*. http://www.finra.org/Industry/Compliance/RegulatoryFilings/RegulationM/ (last visited Jan. 5. 2012).

trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.

§ _.4(a)(4): Definition of underwriter. For purposes of paragraph (a) of this section, underwriter means:

(i) A person who has agreed with an issuer of securities or selling security holder:

(A) To purchase **registered** securities for distribution;

(B) To engage in a distribution of **registered** securities for or on behalf of such issuer or selling security holder; or

(C) To manage a distribution of **registered** securities for or on behalf of such issuer or selling security holder; and

(ii) A person who has an agreement with another person described in paragraph (a)(4)(i) of this section to engage in a distribution of such **registered** securities for or on behalf of the issuer or selling security holder.

**Question 68. What increased costs, if any, would underwriters incur to satisfy the seven proposed requirements of the underwriting exemption? Would underwriters pass the increased costs onto issuers, selling security holders, or their customers in connection with qualifying for the proposed exemption?**

As discussed more fully below in the Cost and Benefits section, any increased costs borne by underwriters are entirely justified given the benefits that a vigorous interpretation of the Volcker Rule would have on depositors, banking entities, the banking market, investors and the global economy as a whole.

**Question 72. Is the proposed definition of "underwriter" appropriate, or over- or under-inclusive in this context? Would an alternative definition, such as the statutory definition of "underwriter" under the Securities Act, better identify persons intended to be covered by the proposed definition? If so, why?**

For further discussion, please see Question 65.

**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?**

For further discussion, please see Question 75.

**<u>Question 74</u>. Is the requirement that the underwriting activities of a banking entity relying on the underwriting exemption be designed to generate revenues primarily from fees, commissions, underwriting spreads or similar income effective? If not, how should the requirement be changed? Does the requirement appropriately capture the type and nature of revenues typically generated by underwriting activities? Is any further clarification or additional guidance necessary?**

Many of the factors that make up the underwriting definition at § _.4(a) are subjective or easy to evade. The Proposed Rule recognizes that banking entities may not legitimately profit from capital gains earned in connection with underwriting activities, and that compensation should instead derive from fees, commissions or spreads. However, the Agencies have not proposed any practical method to effectively police this restriction.

To ameliorate this practical deficiency, we suggest that the Agencies *require automatic disgorgement of any profits arising from appreciation in the value of covered financial positions in connection with underwriting activities*, regardless of whether those profits were intended or not. If the Agencies are serious about requiring that fees be based only on commissions and spreads, they should be willing to enforce that requirement through disgorgement. Any profits that banks earn from capital gains could be disgorged to the affected client (e.g., the issuer of the security), distributed pro rata to the bank's depositors, or paid to the U.S. Treasury as a penalty.

A simple disgorgement standard would obviate much of the complexity that is inherent to the current implementation of the underwriting exemption. For example, the Agencies would no longer need to distinguish between activities supporting near-term client demand from activity taken for speculative purposes. **If a bank were subject to disgorgement, it would no longer have any financial incentive to undertake speculative positions**, given that its compensation would be capped at earned commissions. Similarly, the Agencies would not need to concern themselves with winnowing risk-rewarding compensation arrangements from safe ones. If a banking entity could no longer keep gains from principal risks, it would not create incentives for its employees to take such risks. At most, banks would compensate employees for pursuing underwriting in markets with high spreads (i.e., currently illiquid markets). This result would create strong incentives for increased capitalization in illiquid markets, which should allay some of the concerns that banks have expressed about the Volcker Rule's impact on "liquidity." Indeed, we interpret every comment letter lauding the virtues of market "liquidity"[50] as a further vindication of an explicit disgorgement requirement.

**<u>Question 75</u>. 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? If not, how should the requirement be changed? Are**

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[50] *See generally*, Barbara Shecter, *Chorus of Canadians Blast U.S. Volcker Rule*, FP Street, Jan. 5. 2012. http://business.financialpost.com/2012/01/04/canadians-blast-u-s-volker-rule/.

**there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted underwriting activity? Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?**

Section 619 requires strict compliance with its restrictions on proprietary trading, and not the mere *intention* to comply with those restrictions. The Agencies seemingly lost sight of this fact in drafting the regulatory requirements for permitted underwriting. Sections _.4(a)(vi) and (vii) interpose an element of intentionality into an otherwise strict-liability rule:

> § _.4(a)(vi) The underwriting activities of the covered banking entity are <u>designed</u> to generate revenues <u>primarily</u> from fees, commissions, underwriting spreads or other income not attributable to:
>
> (A) Appreciation in the value of covered financial positions related to such activities; or
>
> (B) The hedging of covered financial positions related to such activities; and
>
> § _.4(a)(vii) The compensation arrangements of persons performing underwriting activities are <u>designed</u> not to reward proprietary risk-taking.

The words "designed" and "primarily" introduce two levels of dilution that can eviscerate the Volcker Rule's restrictions on proprietary trading. A banking entity can easily evade the proprietary trading restrictions by creating facially-complaint policies and procedures that are "designed" to fall within the underwriting exemption, even if they fall short of the exemption in practice. For instance, the Proposed Rule does not forbid a banking entity from benefiting from the appreciation in the value of covered financial positions, so long as the documented "design" of the transaction was to generate revenue from commissions. In fact, **a banking entity is even permitted to intentionally design underwriting transactions to generate revenue from price appreciation**, provided that those revenues are secondary (i.e., not "primary") to fees earned from commissions. Similarly, a banking entity is free to actually reward its employees for proprietary risk-taking, provided that the compensation arrangement was initially "designed" not to. Simply put, the opportunities for evasion are legion.

Accordingly, we recommend the following revisions:

> § _.4(a)(vi) The underwriting activities of the covered banking entity ~~are designed to~~ generate revenues ~~primarily~~ **solely** from fees, commissions, underwriting spreads or other income not attributable to:
>
> (A) Appreciation in the value of covered financial positions related to such activities; or
>
> (B) The hedging of covered financial positions related to such activities; and

§ _.4(a)(vii) The compensation arrangements of persons performing underwriting activities **do** ~~are designed~~ not ~~to~~ reward proprietary risk-taking.

We recognize that Section 619(d)(1)(B) uses the word "designed" in describing underwriting activities that meet near-term demands of clients. Thus, the usage of the word is appropriate in § _.4(a)(v). However, the usage of that word in other contexts, such as § _.4(a)(vi) and (vii), does not enjoy similar statutory support. Further, such usage actually undermines the general intent of Section 619, which requires strict compliance with proprietary trading restrictions.

**Question 77. Does the proposed underwriting exemption appropriately accommodate private placements? If not, what changes are necessary to do so?**

For further discussion, please see Question 65.

**Question 78. The creation, offer and sale of certain structured securities such as trust preferred securities or tender option bonds, among others, may involve the purchase of another security and repackaging of that security through an intermediate entity. Should the sale of the security by a banking entity to an intermediate entity as part of the creation of the structured security be permitted under one of the exemptions to the prohibition on proprietary trading currently included in the proposed rule (e.g., underwriting or market making)? Why or why not? For purposes of determining whether an exemption is available under these circumstances, should gain on sale resulting from the sale of the purchased security to the intermediate entity as part of the creation of the structured security be considered a relevant factor? Why or why not? What other factors should be considered in connection with the creation of the structured securities and why? Would the analysis be different if the banking entity acquired and retained the security to be sold to the intermediate entity as part of the creation of the structured securities as part of its underwriting of the underlying security? Why or why not?**

The Proposed Rule already contains numerous exemptions for permitted proprietary trading. One such exemption, for riskless principal positions taken on behalf of customers, could be utilized for the purpose described in this Question. No separate exclusion is necessary or warranted.

Structured securities of the type described are created for the benefit of the banking entity, not the intermediate entity. Thus, the bank will invariably receive some interest from its role as conveyor of securities to the intermediate entity. Pursuant to Section 619, that interest must not approximate a proprietary position. If the Agencies create an additional exclusion for the conveyance of securities to intermediate entities, banking entities could utilize that exclusion to gain exposure to proprietary positions by buying and selling risky securities to "bad bank" intermediate entities. Furthermore, if the intermediate entity does not qualify as an "affiliate," it could be used by the banking entity as an indirect vehicle to effect proprietary trades.

**<u>Question 79</u>. We seek comment on the application of the proposed exemption to a banking entity retaining a portion of an underwriting. Please discuss whether or not firms frequently retain securities in connection with a distribution in which the firm is acting as underwriter. Please identify the types of offerings in which this may be done (e.g., fixed income offerings, securitized products, etc.). Please identify and discuss any circumstances which can contribute to the decision regarding whether or not to retain a portion of an offering. Please describe the treatment of retained securities (e.g., the time period of retention, the type of account in which securities are retained, the potential disposition of the securities). Please discuss whether or not the retention is documented and, if so, how. Should the Agencies require disclosure of securities retained in connection with underwritings? Should the Agencies require specific documentation to demonstrate that the retained portion is connected to an underwriting pursuant to the proposed rule? If so, what kind of documentation should be required? Please discuss how you believe retention should be addressed under the proposal.**

Public offerings are often highly volatile, as an issuer's securities can be subject to drastic drops in price with little or no notice. Thus, an underwriter's retention of a portion of an offering is an inherently risky proposition. A bank's depositors must not be left "holding the bag" for speculative bets on public offerings that turn sour.

A bona fide underwriter's objective is to push the issuer's securities out to market, and not to retain those securities for speculation, investment or price manipulation. A banking entity falls short of the objectives behind the Volcker Rule to the extent that it has unsold allotments in its banking book in connection with an underwriting. Underwriters are required to conduct extensive due diligence, so they can reasonably be expected to forecast the demand for a particular offering before actually underwriting it. Consequently, the Agencies can fairly require that a bona fide underwriter have little or no unsold allotments. Accordingly, we recommend that the Agencies add an additional factor to the current seven-part test for underwriting, under which the existence of a "substantial" unsold or retained allotment would be an indication of proprietary trading. The term "substantial" would depend on the circumstances of a particular offering. This factor is similar to § _.4(a)(2)(v), which focuses on near-term demands of customers. However, an "unsold allotment" factor would shift the inquiry from something subjective (demands of customers) to a more objective, quantifiable figure (the number of unsold shares in an issue).

Unsold allotments present a conflict of interest vis-à-vis customers. Section 619(d)(1)(B) stipulates that any underwriting activities must be "designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties." Issuers that hire underwriters expect that the underwriter will promote liquidity in the issuer's securities by selling them into the market. Thus, a potential conflict of interest exists whenever a banking entity retains unsold allotments pursuant to an underwriting. Such a conflict would undercut the

banking entity's underwriting exemption by operation of the limitation contained in Section 619(d)(2)(A)(i).

Impermissible conflicts of interest can also arise where allotments of underwritten securities are retained for the purpose of "spinning,"[51] instead of being sold in the market. The practice of spinning allows underwriter insiders to profit from IPO price gains, to the detriment of investors and the issuer. The risk of spinning is more pronounced in unregistered offerings, which have less securities law protection. Notably, spinning is only possible where an underwriter does not sell all of its allotment into the market. Thus, the retention of securities should be viewed by the Agencies with a high degree of scrutiny.

In addition to using the sheer number of unsold securities as an indicator of proprietary trading, the Agencies can also rely on the amount of due diligence documentation compiled by a would-be underwriter. Bona fide underwriting requires extensive due diligence, and so the absence of voluminous diligence documentation would suggest that any unsold allotment is actually a proprietary position. As noted above, under our proposal, the existence of an unsold allotment would not automatically give rise to strict liability, but rather would serve as a factor suggestive of impermissible proprietary trading. However, the combination of a large number of unsold securities and limited diligence documentation should create a very strong presumption of impermissible proprietary trading.

**Question 80. Is the proposed rule's approach to implementing the exemption for permitted market making-related activities (i) appropriate and (ii) likely to be effective? If not, what alternative approach would be more appropriate or effective?**

As a group that includes many former banking industry employees, we recognize and appreciate the complexity of the industry that the Agencies are charged with regulating. It is clear that the Agencies reasonably assumed that this very complicated problem would necessitate a very complicated solution, but unfortunately the end product may be rendered impotent by the excessively broad scope of its exemptions and allowances.

One thing that was overwhelmingly clear to us throughout the Proposed Rule is that many of the current proprietary trading practices can easily continue after implementation of this Rule by enacting only the most superficial changes. It is with this in mind that we conclude that the Rule's approach to the market making exemption may be appropriate, but is very unlikely to be effective.

It is disingenuous to presume that market makers are unable to distinguish between "bona fide" market making activity and proprietary trading. Despite the implication in the extensive

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[51] Jim Naughton. *The Economic Consequences of IPO Spinning*, Harvard Law School Corp. Gov. Forum. Sep. 30, 2009. http://blogs.law.harvard.edu/corpgov/2009/09/30/the-economic-consequences-of-ipo-spinning/.

explanations provided in this Rule, any competent trader certainly "knows it when he sees it"[52] with respect to proprietary trading. We propose two general guidelines that could potentially encourage compliance more easily and with far fewer resources required by the Agencies.

*1. Disgorgement of all Trading Profits*

As has been noted in a variety of venues with respect to this legislation, market making is a "customer service."[53] Typically, customer services are not meant to be profit centers for a business, they are cost centers necessary to facilitate other profitable businesses. Market making, however, is not a service that fits this definition.

In the absence of proprietary profits, it is unclear if market making, especially in illiquid markets, is an inherently profitable business. This conclusion is intuitive as well. By definition, market makers are expected to be selling when customers are buying, and vice versa. Transaction costs and advantageous market information allow for efficient risk mitigation, such that a market maker can constantly renew his capacity to intermediate. If this job is performed constantly and flawlessly, he will reap only a modest monetary profit but tremendous gains in customer satisfaction.

*It is impossible, then, to view large gains or losses as anything other than the result of improper risk taking or negligent hedging within a market making book.* Requiring banking entities to disgorge the profits from market making operations would simply and elegantly remove any element of proprietary speculation, since there would be no incentive to do so. Such incentive alignment would do much more to curb improper activity than would any lengthy legislation.

We have added disgorgement of trading profits to the list of criteria required for the market making exemption in *Annexure B*.

Please see Question 192 for further discussion of this issue.

*2. Strict Penalties for Violation*

Encouraging the practical use of traders' own intuitions and understanding of what is and is not a

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[52] Gary Antsey, *What Experienced Practitioners Know*, Financial Times, Dec. 22, 2011, *available at* http://www.ft.com/intl/cms/s/0/2e3fbbb8-2a5c-11e1-8f04-00144feabdc0.html. ("Paul Volcker is correct in his assertion that proprietary trading is like pornography inasmuch as he 'knows it when he sees it.'").

[53] 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("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.").

proprietary risk will be the most efficient way to cut down regulatory complexity in this rule. We submit the following truths for the Agencies' consideration:

- Traders are acutely and constantly aware of which of their trades are in fact customer serving.

- Demonstrating this for any particular trade is simple, and evidence should not be difficult to provide–even within the limits of current operational regimes within most banking entities.

- Taking proprietary risks has significant benefits and few downsides for individual traders, and so proprietary risk-taking will continue to be attractive despite the implementation of this Rule.

In theory, these upside/downsides should be controlled and equated by firms' attempts to manage risk, but for many reasons this has never been the case. It is our opinion that **addressing this risk/reward disparity is precisely where regulators are most necessary and can be most effective in exacting real, meaningful changes**. If traders and managers are held personally responsible for violations of this Rule by facing fines and criminal penalties, a culture of voluntary compliance would emerge organically.

For further discussion, please see Question 214.

**Question 81. Does the proposed multi-faceted approach appropriately take into account and address the challenges associated with differentiating prohibited proprietary trading from permitted market making-related activities? Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?**

This comprehensive approach to adequately differentiating between the two kinds of trading activity is laudable. The goal of inhibiting excessive risk taking without stifling the engine of healthy markets requires thoughtful negotiation between safety and growth, and will result in a delicate balance. It is clear that absolute results are impractical, and perhaps the best outcome is one where Team Safety (Regulators) and Team Growth (Banks) both feel equally undermined by the final result.

As it is currently written, we see that the Agencies' proposed multi-faceted approach has endeavored to use every tool at their disposal to assist in this differentiation, and we are supportive of this. The precise implementation of these tools, however, needs a tremendous amount of refining to be effective. Our specific concerns will be addressed in the following questions.

**7 Market Making Criteria:** We provide a more detailed discussion of the list of criteria in Question 87, but in general we find the criteria to be necessary, but not sufficient. Most troubling are the extremely imprecise definitions and indicia of market making in liquid and illiquid markets. The many broad allowances for inconsistent activity come across as a list of possible disguises for proprietary trades, and the implication is that the Agencies do not intend to be scrupulous here in their enforcement. We sincerely hope that this was not the intention, and is not the case. This particular issue of differentiating prohibited trading from permitted activity is one of the most central to this Rule and it is imperative that the covered banking entities, and the Regulatory Agencies, take it seriously.

**Consistency with the Commentary:** The Commentary is appropriate for only the most liquid and transparent markets (i.e., listed equities, treasuries), and fails to accurately describe market making in most illiquid or OTC markets. This general reliance on highly liquid markets as a model for all trading activities is found throughout the Rule. We find this particularly troubling, given that such markets were not considered to be contributors to the most recent crisis, and are not expected to become risk factors in the future. Illiquid markets were and continue to be havens of risky and irresponsible activity, yet they are largely forgiven throughout this rule. We have submitted an alternative Market Making Commentary with this letter, at *Annexure C*, which reflects our suggested changes.

**Reporting Requirements:** The quantitative measurements are an important reporting requirement, but leave ample room to misrepresent overall activities, bypass requirements, and explain away inconsistencies. This issue is discussed further in its relevant section.

A straightforward addition to this approach that could ensure a tremendous amount of voluntary compliance is **an explicit prohibitive penalty for violation**. We are concerned that the Proposed Rule's multi-faceted approach mirrors that recommended by the FSOC Study, **except for** the requirement for enforcement procedures:

> The study recommends Agencies consider a four-part supervisory framework to assist banking entities and Agencies in distinguishing prohibited proprietary trading from permitted activities, consisting of:
>
> 1. Programmatic compliance regime;
> 2. Analysis and reporting quantitative metrics;
> 3. Supervisory review and oversight; and
> 4. **Enforcement procedures for violations**[54]

[54] Financial Stability Oversight Council, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds at 15 (Jan. 18, 2011) (emphasis added), *available at*

Although the complicated guidelines of the Proposed Rule imply otherwise, it is unrealistic to presume that traders cannot distinguish between market making and proprietary trading. Further clarity is unnecessary if the valuable intuition of the traders is properly incentivized. It is worth noting that the FSOC Study **repeatedly**[55] advises the clear and explicit use of penalties as a core component of this legislation, but specific discussion of penalties is largely absent from the Proposed Rule text.

An additional consideration that goes unaddressed throughout the Proposed Rule, and is of particular concern regarding the complex multi-faced approach, is the tremendous amount of resources required *by the Agencies* to effectively administer such a complicated system. It is reasonable to assume that the Agencies will need to find ways to devote such resources to ensure proper implementation of this multi-faceted approach, or else the Rule will proceed unmonitored, unenforced, and useless.

**Question 82. Does the proposed multi-faceted approach provide banking entities and market participants with sufficient clarity regarding what constitutes permitted market making-related activities? If not, how could greater clarity be provided?**

What we gleaned from the multi-faceted approach is as follows: In those instances where an explicit line between permitted and prohibited activity can be drawn, the Agencies have done so. Where such a differentiation is more complicated, the Agencies will deem most activity to be permitted. We are troubled by the fundamental equation of "what is permitted" to "what will be enforced." The latter is sufficiently clear. The former, however, remains overwhelmingly obscured. A glaring example of this is in the treatment of gains from capturing bid/offer spreads in illiquid markets. We provide a basic example to illustrate some of the important failings in the practical implementation of this revenue requirement:

> *A market maker in an illiquid bond provides regular indicative markets that are 0.25pt wide, which is seen as standard bid/offer size for this bond. In a given day he conducts 10 trades: 5 buys and 5 sells, all of standard equal size. 3 of these trades were conducted with clients, and 7 through an inter-dealer broker. Other*

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http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20619%20study%20final%201%2018%2011%20rg.pdf [hereinafter FSOC Study].

[55] *Id.* at 3 ("Require divestiture of impermissible proprietary trading positions and impose penalties when warranted."). *See also id.* at 6 ("[Existing remedies] should not preclude Agencies from considering other potential supervisory or enforcement actions such as increased oversight, reductions in risk limits, increased capital charges, or monetary penalties. Also, it should not insulate proprietary trading from other applicable provisions of law."); *id.* at 32 ("Banking entities should be subject to strong supervisory consequences and penalties for violations, which should include termination of the activity or disposal of the investment, and other legal sanctions as appropriate"); *id.* at 41 ("[T]here should be strong penalties for traders or salespeople that make a practice of mischaracterizing trader-initiated trades as customer-initiated trades.").

*trades in this bond occur throughout the day away from this market maker. On average, the trader sold the bonds 1pt higher than he bought them.*

When considering the activity of this trader with respect to compliance with the Proposed Rule, the following questions emerge: Were these trades considered legitimate market making activities, or were some trades clearly market making related, and others potentially proprietary trading? Would all profits be considered legitimate capture of bid/offer spread, or would some portion be attributed to spread, with the balance prohibited? Can meaningful data be provided to assist the Agencies in determining the nature of this activity?

We concede that the activity described in this particular example is over-simplified, and (prohibited or not) it would not by itself reasonably warrant a second look. But in practice, this bond would be one of many traded by a market maker. It may in fact be used to offset one or many other positions or even products. It may, as is often the case, have been a small piece of a large and complicated proprietary strategy within a trading book. When this scenario is imagined with trades of sufficient size, and is multiplied across a number of different trading books, the risks accumulate rapidly and such activity cannot be reasonably assumed to be benign.

The addition of "bright-line" prohibitions of risky activity within the market making exemption is **crucial**. If legitimate market making activities of a security requires, or otherwise causes, a banking entity to assume large illiquid positions (as the industry claims it must),[56] and those positions cause the banking entity to endure significant losses (as they famously and repeatedly have done), this rule would be considered a failure.

**Question 83. What impact will the proposed multi-faceted approach have on the market making-related services that a banking entity provides to its customers?**

If this Proposed Rule succeeds in redefining the landscape of risk-taking within covered banking entities, it will surely require time and resources from the industry to adapt and accommodate the new structure. Despite the disingenuous claims from affected firms and their lobbyists, it is unclear that this rule, as written, will markedly alter the current customer-serving business. Indeed, this rule has gone to excessive lengths to protect the covered banking entities' ability to maintain responsible customer-facing business. At times it has even done so at the expense of clear and firm rulemaking.

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[56] *See, e.g.*, SIFMA. *The Volcker Rule Restrictions on Proprietary Trading: Implications for the US Corporate Bond Market* 9 (Dec. 2011) (study prepared by Oliver Wyman Group for SIFMA in exchange for compensation). *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=8589936887.
("[T]o serve customers in less liquid asset classes. dealers must hold inventory well in excess of trading volume.") [hereinafter SIFMA & Oliver Wyman].

**How will the proposed approach impact market participants who use the services of market makers?**

To the extent that current business structures remain intact, we expect that customers will in fact see significant benefits from this approach:

- Their interests will become aligned with those of the banking entity. (i.e., customers will no longer be seeking a "customer service" from a market competitor).
- Assets will be priced according to more realistic market liquidity, supply and demand, and associated risks (i.e., prices will no longer be subsidized by other proprietary profits, and bid/offer spreads will align with actual market depths, etc.).
- The net provision of liquidity by market makers will increase as they continue to provide, but cease to simultaneously "take," liquidity through proprietary activities.

If it is the case that certain businesses prove to be unviable within covered banking entities following implementation of this Rule, a period of adjustment will be uncomfortable but necessary throughout the industry. One obvious aspect of this adaptation will be the emergence of new firms that seek to capture the profitable intermediary business that is exited by banking entities. In consideration of the necessary growing pains associated with such adaptation, it should be noted that **many firms are already well positioned and eager to enter or expand within this business**, and such firms should be expected to ease such transition.[57] The customers of banking entities will face the burden of navigating a new pool of service-providers as roles readjust throughout the market. Their relationships with covered banking entities, however, will improve dramatically as conflicts of interest are eliminated and true customer service is prioritized.

**How will the approach impact the capital markets at large, and in particular the liquidity, efficiency and price transparency of capital markets?**

It has become common understanding in the years since the onset of the financial crisis that the single most important contributor to ensuring functional liquidity in markets is a healthy and safe banking system. This Proposed Rule, despite its shortcomings, will do more to promote the

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[57] Laura Marcinek & Erik Schatzker, *Lutnick Says Dodd-Frank Law May Be 'Violently Beneficial' for BGC Partners*, Bloomberg. Jan. 11, 2012. *available at* http://www.bloomberg.com/news/2012-01-11/lutnick-says-dodd-frank-may-be-violently-beneficial-for-bgc.html (quoting Howard Lutnick. CEO of inter-dealer broker BGC Partners as saying that "Dodd-Frank will either be beneficial. or violently beneficial for BGC Partners, I'm just not sure which one").

safety and soundness of the covered banking entities and banking system at large than any other piece of legislation since Glass-Steagall.

The idea put forth by industry lobbyists and trade groups, that the removal of a government subsidy within a segment of market makers will cause serious and permanent market-wide reductions in liquidity,[58] defies both common sense and the foundations of free-market capitalism. We urge the Agencies to keep sight of the fact that a proprietary trading platform embedded within a client-intermediation business is extremely profitable, and those firms outside the scope of this legislation will happily act to fill any holes that are created by this approach. The market will move to provide the liquidity it needs, without regard for the federal backing of the providers.

We do not believe that the NPR will have a significant effect on price transparency or efficiency. Concrete changes could be made to promote efficiency and transparency, such as requiring all standard products to trade on exchanges, requiring real-time public reporting of price and transaction data, and re-defining "bona-fide" market making such that it mandates continuous *tradable* quotations on a multilateral electronic trading facility. These changes would have a tremendous impact on transparency and efficiency throughout capital markets. Merely restricting proprietary trading in covered banking entities, however, will not.

**If any of these impacts are positive, how can they be amplified? If any of these impacts are negative, how can they be mitigated?**

Our position, as described above, is that the Proposed Rule will have little lasting adverse impact on liquidity, transparency, or efficiency. Consistent with that reasoning, we see no benefit, and meaningful public risk, in retaining *any* trading operations within federally backstopped institutions, unless they are trading strictly on behalf of customers.

**Would the proposed rule's prohibition on proprietary trading and exemption for market making-related activity reduce incentives or opportunities for banking entities to trade against customers, as opposed to trading on behalf of customers? If so, please discuss the benefits arising from such reduced incentives or opportunities.**

We see the alignment of interests of market makers and their clients as one of the most important effects of the Proposed Rule. The current market structure, wherein proprietary trading market-maker hybrids are presumed to provide an unencumbered "service" to customers, is clearly rife with conflicts of interest. In all markets, market makers are provided with valuable market flow information in exchange for acting as an on-demand counterparty. The understanding is that a good market maker will make use of that information to efficiently manage client flow, such that he can sell what he buys for a nominal profit and re-up his capacity to take on his clients' trades.

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[58] *See, e.g.*, SIFMA & Oliver Wyman, *supra* note 56.

When a market maker is also acting as a proprietary trader, however, this flow information (i.e., the size and timing of his clients' investments) exists as the basis for his proprietary strategy. What this implies, and certainly what we have experienced in practice, is that ***a market maker effectively profits from proprietarily front-running his clients***. Clients know this, but banks have long colluded to ensure the continuation of a system with few alternatives for intermediation.

**Question 84. What burden will the proposed multi-faceted approach have on banking entities, their customers, and other market participants?**

The largest and most vocally-opposed effect on banking entities will be the reduction in highly-profitable proprietary trading within their market making businesses. This is a necessary consequence, and we feel it unworthy of reconciliation in the context of this Rule's intent. Senator Conrad put the costs of implementing this legislation into perspective in his explanation to Congress: "[t]his bill is an insurance policy against an expensive future taxpayer bailout."[59]

It is offensive to suggest that the burden of diminished revenues for banking entities may outweigh the significant improvements to the safety and soundness of the banking industry that will result from proper implementation of this Rule.

Additionally, a costly but necessary reorganization of skillsets within banking entities must take place. Those individuals who are skilled proprietary traders are not necessarily the same as those who are skilled customer-servicers with respect to market making. This complicated reorganization, however, will hopefully be facilitated by the concurrent shift in compensation incentives across banking entities. Skilled proprietary traders will be better paid in hedge funds and other entities where risk-taking is valued and rewarded. Similarly, those with the ability to effectively serve customers while minimizing risk will be attracted to the trading desks of covered banking entities, where their skills will now be in demand.

The customers of banking entities will face the burden of navigating a new pool of service-providers as roles readjust throughout the market. Their relationships with covered banking entities, however, will improve dramatically as conflicts of interest are eliminated and true customer service is prioritized.

Other market participants, particularly those who seek to inherit profitable businesses previously monopolized by covered banking entities, will experience considerable benefits[60] due to the proposed approach. We have found little evidence that the implementation of this Rule in

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[59] 156 Cong. Rec. S5893 (daily ed. July 15, 2010) (statement of Sen. Conrad).

[60] Marcinek & Schatzker, *supra* note 57 (quoting Howard Lutnick, CEO of inter-dealer broker BGC Partners as saying that "Dodd-Frank will either be beneficial, or violently beneficial for BGC Partners, I'm just not sure which one").

general, or this approach specifically, will have any permanent or adverse effects on financial markets at large.

For further discussion, please see Question 83.

**How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?**

As stated above, this burden is the effect of an appropriate reallocation of costs and services within the market, and should not be minimized or eliminated.

**Question 85. Are there particular asset classes that raise special concerns in the context of market making-related activity that should be considered in connection with the proposed market-making exemption? If so, what asset class(es) and concern(s), and how should the concerns be addressed in the proposed exemption?**

Over-the-counter (OTC) markets, complex derivatives, and other illiquid markets present various important concerns. We have taken much time and care in addressing the various challenges in implementing this rule in illiquid and opaque markets, and these thoughts are presented below. However, we have concluded that a meaningful interpretation of the intentions of the statute would prohibit *all* activities in these instruments.

Risky products, such as illiquid bonds, credit default swaps (CDS), and other complex derivatives, were precisely those instruments that contributed to the financial crisis in 2008, and those that this legislation sought to expel from federally-backstopped banking entities. We find it disingenuous to suggest that this was not commonly understood by the banking entities, the regulators, and the public long before this Proposed Rule was drafted. Senator Merkley explicitly addressed the prohibition of market making in both credit default swaps and other "high risk instruments." He explicitly calls out credit default swaps as a high-risk instrument:

> 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.[61]

Sen. Merkley also makes clear that any trading of high-risk assets is not to be permitted whether or not they qualify for the market-making exemption:

> Barring high-risk strategies may be particularly critical when policing market-making-related and hedging activities, as well as trading otherwise permitted under subparagraph (d)(1)(A). In this context, however, it is irrelevant whether or

[61] 156 Cong. Rec. S5894 (daily ed. July 15. 2010) (statement of Sen. Merkley).

> not a firm provides market liquidity: high-risk assets and high-risk trading strategies are never permitted.[62]

We are troubled by the ways in which this very clear explanation was ignored throughout this Proposed Rule. Credit default swaps are hardly among the riskiest securities traded on market making desks, which indicates that the scope of the Senator's statement is far reaching. We see no reasonable way to implicitly allow for market making in CDS, or similar products, anywhere in this Proposed Rule.

Additionally, is clear that Congress's intentions were not to include illiquid markets within the market making exemption. Take, for example, this scenario referred to by Senator Merkley in the Congressional record regarding this Proposed Rule:

> 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.*[63]

The senator rejected the implication that a one-sided market (a market with only a bid or an ask) is a legitimate one, with respect to market making: "one-sided marketing or selling securities is not equivalent to providing a two-sided market for clients buying and selling securities."[64] This speaks both to bespoke structured products, which markets are "made" by creating and marketing non-standardized derivatives to clients, as well as standardized instruments that trade infrequently and lack consistent market support. **The nature of all illiquid markets is that they exist primarily as one-sided markets** at any point in time. OTC markets operate with *no requirement* that a market maker provides realistic and tradable prices in these products at all times. Nor are there systems that would allow the Agencies to monitor or confirm such activity. Despite the Senator's clear declaration of the statute's intent, the Supplementary Information of this Proposed Rule explicitly allows for one-sided markets in illiquid products by including them in the indicia of bona fide market making:

> With respect to securities, regularly purchasing covered financial positions from, **or** selling the positions to, clients, customers, or counterparties in the secondary market.[65]

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[62] *Id.*
[63] *Id.* at S5896 (emphasis added).
[64] *Id.*
[65] NPR at 68,871 (emphasis added).

Further, market makers are often willing to provide neither an executable bid nor ask in illiquid securities. This is precisely what makes such a market "illiquid." We feel that it is impossible to reconcile the clear intentions of congress with the allowance for illiquid and opaque products.

In the most liquid and robust markets, contemporaneous buyers and sellers can theoretically exist such that the underlying "price" is not affected as bid/ask spreads are captured. In practice, such markets charge exceedingly small spreads, since bid/asks often serve as a proxy for liquidity premiums and the job of intermediation requires little risk. Incidentally, these markets often charge commissions or fees on top of bid/offer spreads, and many trade on organized trading platforms or exchanges where market making activity can be easily monitored (as in listed equities). Identifying the source of revenues is reasonably straightforward in these markets, and the Proposed Rule has designed robust measures to enact and enforce the prohibition on proprietary trading within them. In general, we are satisfied with the Proposed Rule's effectiveness within liquid markets, and applaud efforts to ensure such broad and meaningful oversight.

In contrast, the riskiest and most troublesome activity occurs in those markets that share very few of the features described above. Illiquid securities and complex Over-the-Counter (OTC) derivatives typically trade infrequently and opaquely, outside of organized platforms, and without the convention of fees or commissions. In essence, these products lack all of the necessary qualities to facilitate even the most basic implementation of this Proposed Rule. Regulators will be unable to monitor, verify, or enforce this rule in any meaningful way with respect to these products, and they provide myriad opportunities for large proprietary positions to be justified, disguised, or overlooked.

In particular, we will discuss here the characteristics of illiquid and complex products that most undermine the effectiveness of the Proposed Rule, and suggest amendments and improvements for the Agencies' consideration.

- *Bid/Ask Spreads*

The allowance for bid/offer revenues in market making is one of the largest opportunities for abuse of the Rule's proprietary trading prohibition. In his discussion of this legislation, Senator Merkley described how market making revenues should look:

> Generally, the revenues for market making by the covered firms should be made from the fees charged for providing a ready, two-sided market for financial instruments, and not from the changes in prices acquired and sold by the financial institution.[66]

[66] 156 Cong. Rec. S5896 (daily ed. July 15. 2010) (statement of Sen. Merkley).

The designation of bid/ask spreads as appropriate market making revenue is not mentioned, as the generation of such revenue relies exclusively on changes in the market value of the positions or risks held in inventory. "Revenues **primarily** from fees, commissions, bid/ask spreads or other similar income"[67] is functionally identical to "all revenues," to the degree that they can be meaningfully differentiated.[68]

The attempt to reconcile these two conflicting ideas is a primary source of complexity throughout this Proposed Rule, and it serves to meaningfully diminish its effectiveness in practice. The FSOC Study indeed highlighted this issue[69] in its recommendations, and yet it remains as a cornerstone of the Rule's structure.

There are few reasonable solutions to the regulatory problems posed by bid/offer spreads within illiquid markets. Our primary recommendation would be to honor the statute by removing illiquid and OTC products from the market making exemption. An alternative remedy would be to require the disgorgement of all profits from market making related activities.[70] This would eliminate the problem of differentiation of revenues, in addition to significantly reducing the incentive to take prohibited proprietary exposures. For further discussion, please see our answer to Question 82, where we provided a basic example to illustrate some of the failings of the implementation of the revenue requirement.

- *Hedging*

The complicated risk profiles of derivative products require a variety of piecemeal trades to hedge each component risk, and each of these hedges presents new exposures that also require hedging. The trading books of such products quickly become a complicated web of inter-dependent trades that are increasingly difficult to adequately unwind. Illiquid products, for which good hedges rarely exist,[71] are mitigated through proxy hedges[72] that are imperfect

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[67] NPR at 68,872 (discussion of the fifth market making criterion, § _.4(b)(2)(v)) (emphasis added).
[68] The inclusion of the word "primarily" serves to further erode this requirement.
[69] FSOC Study, *supra* note 54, at 24 ("[M]easuring the revenue that is attributable to the bid-ask spread is difficult and not consistently observable especially in illiquid markets.").
[70] We emphasize that customer-services are rarely profit centers, and the necessity of profiting from the customer-service of market making should not be taken for granted.
[71] *See* AllianceBernstein's Comment Letter re Prohibitions and Restrictions on Proprietary Trading – File S7-41-11 6 (Nov. 16, 2011), *available at* http://www.federalreserve.gov/SECRS/2011/November/20111129/R-1432/R-1432_111611_88542_412445985793_1.pdf ("Certainly there are segments of fixed income markets and OTC markets where such hedges do not exist or markets where even the best structured hedges fail to protect the hedging party fully. It is impossible to predict what the behavior of even the most highly correlated hedge will be versus the underlying asset being hedged.").
[72] Interview by Financial Crisis Inquiry Commission with David Bushnell, Former Chief Risk Officer for Citigroup 45 (Apr. 1, 2010), *available at* http://ebookbrowse.com/2010-04-01-transcript-of-fcic-staff-interview-with-david-bushnell-citigroup-pdf-d250783037 ("[I]n this secondary trading desk they would take positions in different tranches of CDOs, triple B, single A, double A positions, to facilitate customer liquidity and customer inquiries. If

(indeed sometimes completely unrelated), but available and economical.[73] In other cases, such risks are seen as uneconomical to hedge at all.[74] This issue is addressed in greater detail below.

- *Warehousing Illiquid Risk*

In explanation of the statutory prohibition of high-risk assets and strategies[75], Senator Merkley stated:

> With respect to the definition of high-risk assets and high-risk trading strategies, regulators should pay close attention to the characteristics of assets and trading strategies that have contributed to substantial financial loss, bank failures, bankruptcies, or the collapse of financial firms or financial markets in the past, including but not limited to the crisis of 2008 and the financial crisis of 1998. In assessing high-risk assets and high-risk trading strategies, particular attention should be paid to the transparency of the markets, the availability of consistent pricing information, the depth of the markets, and the risk characteristics of the assets and strategies themselves.[76]

There were few greater contributors to the most recent financial crisis than the warehousing of large illiquid positions. The accumulation of assets for which there is no willing buyer or price clarity is a very risky practice. When this happens throughout an industry that relies heavily on very short-term (often overnight) funding, this practice can prove to be systemically disastrous. It is inconsistent with Congressional intent for the Rule to create allowances for businesses that require significant risk-taking as a matter of course; unfortunately, that is the very nature of market making in illiquid products. This issue is a major concern of the FSOC Study, which states that inventory management related to market making "is especially complex in illiquid markets, as a market maker may be required to assume significant market risk between the time that the large order is purchased and sold back into the market."[77]

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they happened to be holding a position and they wish to hedge its price volatility, they would use another instrument, ABX indices which traded. in an attempt to hedge the price volatility of the position that they had.").

[73] *See* 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley). Senator Merkley alluded to such hedging practices in his description of the events leading to the 2008 financial crisis: "commercial and investment banks drove into increasingly risky, short-term, and sometimes theoretically hedged. proprietary trading." *Id.*

[74] FSOC Study, *supra* note 54, at 20 ("In general. it may be uneconomical to completely hedge all of the risk to which a trading desk is exposed.").

[75] Proposed Rule § _.8(d)(2)(A)(ii) ("No transaction, class of transactions, or activity may be deemed a permitted activity [] if the transaction, class of transactions. or activity [] would result. directly or indirectly. in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as such terms shall be defined by rule as provided in subsection (b)(2))).

[76] 156 Cong. Rec. S5897 (daily ed. July 15. 2010) (statement of Sen. Merkley).

[77] FSOC Study, *supra* note 54, at 19.

We are unable to reconcile the allowance for market making in illiquid assets with either the intentions of Congress, the guidance of the FSOC Study, or the true intention of the Agencies to prohibit potentially harmful activities within covered banking entities.

- *Provision of Meaningful Data*

The implementation of this Rule relies heavily on the idea that prohibited proprietary activity can be identified through thoughtful analysis of quantitative trade data. This concept in itself raises serious concerns, as we will discuss in greater detail later in this document. But in any case, this idea requires that reasonably accurate and meaningful data can be collected. Illiquid and OTC markets simply cannot provide much of the relevant data, either because market conventions deem it inapplicable, or because no systems are in place to reliably capture it. For example, customer initiations cannot be monitored in OTC markets, inventory turnover is not meaningful for derivatives, and bid/ask spreads are subjective and unreliable for illiquid products.

Former SEC Chairman Harvey Pill recently stated:

> First, there has to be a universal requirement that anyone that takes money from the public that can have an impact on the economy must provide a continuous flow of significant data.[78]

Illiquid and OTC products are unable to provide such data, and their place in the trading desks of banking entities must be reconsidered. This rule cannot be effectively enforced in the very markets where it is most necessary (OTC markets where stability and liquidity are most lacking). Allowing any trading activity to make use of this exemption should be required to demonstrate that they religiously perform their business such that this requirement is consistently and obviously met. We urge the Agencies to require all market making-related activities to be conducted on a multi-lateral organized electronic trading platform or exchange such that the necessary market factors can be monitored and confirmed. Such necessary factors include:

- Time of trade execution
- Classification of counterparties (client or dealer)
- Demonstrated provision of regular, continuous, and contextual bid and offer prices
- Aggressor Identification (which party was the provider or taker of liquidity)
- Market side (execution down at the bid or up at the offer)

- *Near-term Demands*

[78] Interview by PBS Frontline with Harvey Pitt, Former Chair. Securities & Exchange Commission, *available at* http://www.pbs.org/wgbh/pages/frontline/warning/themes/ought.html (last visited February 4. 2012).

The requirement that market making–related activities not exceed the reasonably expected near-term demands of clients presents serious potential conflicts of interest, in addition to its lack of applicability to illiquid and OTC markets. We have removed this language from the Commentary, as outlined in *Annexure C*.

The definition of good and useful market making does not depend on the nature of the market being made. If any instrument or market cannot the meet the requirements of this Rule, changes should be required within that market in an attempt to conform, otherwise it should be considered prohibited activity.

**Question 86. Are there other market making-related activities that the rule text should more clearly permit? Why or why not?**

The extensive permissions render the proprietary trading prohibition, with respect to market making, entirely ineffective. It would be entirely negligent of Congressional intent to suggest that further permissions may be appropriate.

**Question 87. Are the seven criteria included in the market-making exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other criteria be added?**

As discussed in Question 85, the seven criteria are applicable to only a small group of highly liquid assets. To all illiquid and OTC products, most of the proposed criteria are completely ineffective. We discuss each of the criteria in detail below.

*1) Establishment of Internal Compliance Program*
A comprehensive compliance regime is certainly the cornerstone of effective corporate governance, and we are pleased with the priority that this was given throughout the Proposed Rule. We do, however, find that the programmatic requirements in this Proposed Rule have some serious shortcomings, and we would strongly caution against placing undue reliance on this facet.

It is worth emphasizing that all major banking entities have had extensive compliance regimes in place for many years, and yet they did not prevent the various systematic failures that occurred in the 2008 financial crisis. In our experience, as a group that includes current and former compliance officers, risk managers, IT professionals, and traders, the general attitude toward compliance throughout the industry is one of contempt. Compliance requirements are viewed as a nuisance, and compliance officers are frequently ignored. This attitude yields evasion of rules, incomplete or inaccurate data, and manipulation of programmatic weaknesses. That being said, we do not mean to diminish the dire necessity of robust compliance policies and procedures throughout banking entities. At the very least, we hope to discourage over-reliance on, and unrealistic expectations for compliance regimes within a regulatory framework. At best, we

hope to highlight the need for a cultural overhaul within banking entities such that these kinds of policies and procedures are met with due attention and respect. We hope that the Agencies make this a priority, to the extent that they are able to do so.

A straightforward way to improve the efficacy of compliance regimes is to enact a re-focusing of compensation incentives within compliance organizations of covered banking entities. A two tiered approach could 1) bring the general level of compensation of compliance professionals to be more in line with those in the front office, to more accurately demonstrate the importance of these roles to the quality of the banking entity itself, and 2) require a compensation design which explicitly rewards quality practices and their implementation.[79] Similarly, banking entities would be served by applying the same structural changes to other important operational groups such as Product Control, Operational Risk Management, and Information Technology.

*2) Bona Fide Market Making*
As we discussed in Question 85, the clear attribution of market making is difficult in all illiquid and OTC markets. We propose an alternative definition of market maker in Question 88.

*3) Reasonably Expected Near-term Demands of Clients, Customers, and Counterparties*
Liquid, exchange-traded products often make use of metrics of market transparency to provide market makers with useful information about market depth, which in turn allows them to form reasonable expectations about their customers' near-term demands.[80] All other markets (namely OTC and illiquid) lack the fundamental structure that allows for such insights. In practice, such near-term demand is most often estimated by vague intuitions like: "The market is going up, so my clients will probably want to be buyers,"[81] more troublingly, "I want to buy here, so my clients will likely want to buy as well," or unlawfully, "I have non-public information that indicates that my clients will be buyers." This concern was raised in the Supplementary Information for this Proposed Rule,[82] but the Rule fails address this concern by requiring that the other sources of such information be demonstrable and verifiable by regulators.

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[79] Programs such as the SEC's Whistleblower program are a relevant incentivization program that may be used as a reference for such reforms. Sec. & Exch. Comm'n, *Dodd-Frank Act Rulemarking: Whistleblower Program*, http://www.sec.gov/spotlight/dodd-frank/whistleblower.shtml (last visited February 4, 2012).
[80] For instance, such information can include Level 2 market data or NASDAQ's Depth of Book data.
[81] *See* Mark Pengelly, *Finding Volcker Rule Metrics will be Tough, Dealers Warn*, Risk.net, Aug. 1, 2011, http://www.risk.net/risk-magazine/feature/2096530/finding-volcker-rule-metrics-tough-dealers-warn ("We're not a pure agency business or a proprietary trading operation – we're a principal trading business. If a trader comes in first thing in the morning and sees that S&P 500 volatility is trading cheap, we'll buy $10 million of it. Trading in advance to facilitate client activity is part of what we do.").
[82] NPR at 68,871 (discussion of the third market making criterion, § _.4(b)(2)(iii)) ("In order for a banking entity's expectations regarding near-term customer demand to be considered reasonable, such expectations should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects.").

Specifically, a market maker could justify the accumulation of prohibited proprietary exposures by claiming that they are driven by his unique understanding of his client base and their expected activity. Such a claim would be practically impossible to confirm, particularly as the markets become less liquid or standardized. Even more alarming is the functional similarity between such activity and the common understanding of front running.

Conventional market makers have always walked a very thin line between legitimate client intermediation and illegal front running. As market makers contemporaneously execute customer orders and proprietary strategies, it is often difficult to meaningfully differentiate between true trading profits and potentially ill-gotten gains. In general, it is our expectation that the reduced capacity for market makers to take proprietary positions as a result of this Rule will move to significantly re-align the interests of banking entities and their customers.

This effect, however, will be seriously undermined by what we see as a significant logical error in the structure of the market making exemption in this Proposed Rule. Namely, the classification of "near-term customer demand" in the Supplementary Information serves to *require* a market maker to effectively front run his customers in order to qualify for the exemption. We take the following legal definition of front running:

> Frontrunner[s] use their access to material nonpublic market information to take unfair advantage of other market participants.[83]

The proposed rule makes it very clear that a banking entity may *not* accumulate inventory in advance of customer trades, unless such accumulation is based on specific information about the near-term demands of their client base. Presumably, such specific future flow information would be considered "nonpublic." Further, banking entities may *not* base such anticipatory accumulation on what would be public information, such as general market expectations of price appreciation. We see in the NPR's discussion of § _.4(b)(2)(iii):

> In order for a banking entity's expectations regarding near-term customer demand to be considered reasonable, such expectations should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects. Rather, a banking entity's expectation should generally 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.*[84]

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[83] U.S. General Accounting Office. *Securities and Futures Markets: Efforts to Detect Intermarket Frontrunning*, GAO/B-245321 (Washington, D.C.: Sep. 26, 1991), *available at* http://archive.gao.gov/d18t9/145088.pdf.
[84] NPR at 68,871 (emphasis added).

It is difficult to imagine a situation then, where a banking entity would be accumulating demand based on legitimate public information that is "related to clear, demonstrable trading interest of clients, customers, or counterparties"[85] as such information is indeed rarely made public.

We see the clear potential for conflict and confusion with respect to this rule, and suspect that market makers may begin engaging in increasingly conflicted activities under the protection of this Rule. We see the demand anticipation criterion as not only unnecessary to the description of bona fide market making, but also a potential source of great divergence in the interests of market makers and their clients. This potentially harmful conflict of interest was highlighted in the FSOC study,[86] and we urge the Agencies to reconsider the appropriateness of this requirement in light of the coinciding statutory prohibition of such a conflict.[87] Anticipatory accumulation of inventory should be removed from the description of market making, and considered to be prohibited proprietary behavior.

We recognize that this Proposed Rule draws directly from the language of the statute. However, this potentially harmful conflict of interest was highlighted in the FSOC Study,[88] and we urge the Agencies to reconsider the appropriateness of this requirement in light of the coinciding statutory prohibition of such a conflict.[89]

Generally, we conclude that the assumption underlying the Supplementary Information's description of this allowance is that market makers are engaged in substantive and trusting relationships with their client base. This situation is idealized, extremely rare, and highly unreliable. In practice, this level of trust can (and often does) translate into an "Order Basis" relationship, meaning the market maker is given the exclusive direction to execute at a given price on behalf of a client. Clearly, such agency activity would not require the significant accumulation of inventory to meet future demand. We would like the Agencies to consider the

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[85] *Id.* (discussion of the second market making criterion. § _.4(b)(2)(ii)) ("bona fide market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.").

[86] FSOC Study, *supra* note 54, at 48 ("Proprietary trading presents potentially serious conflicts of interest between a firm's activities that take a directional view and the customer-serving activities that should facilitate proper functioning of markets. A customer could unknowingly suffer financial injury if, for example, the firm were to trade ahead of customer orders or anticipated orders for financial instruments and profit from changes in the market price resulting from the customer's order. Or the firm could trade based on information about a future underwriting deal for the customer, or knowledge of a customer's portfolio of securities.").

[87] 12 U.S.C. § 1851(d)(2)(A)(i).

[88] FSOC Study, *supra* note 54, at 48 ("Proprietary trading presents potentially serious conflicts of interest between a firm's activities that take a directional view and the customer-serving activities that should facilitate proper functioning of markets. A customer could unknowingly suffer financial injury if, for example, the firm were to trade ahead of customer orders or anticipated orders for financial instruments and profit from changes in the market price resulting from the customer's order. Or the firm could trade based on information about a future underwriting deal for the customer, or knowledge of a customer's portfolio of securities.").

[89] 12 U.S.C. § 1851(d)(2)(A)(i).

value of risk-taking market-makers in the following context: those market-makers that can accurately and reliably estimate near-term customer demand could potentially perform their function nearly as well on an agency basis. Consequently, those who cannot do so should not meet the requirements of the market-making exemption.

*4) Revenues from Fees, Commissions, Bid/ask Spreads or Other Similar Income*
This is perhaps the most complicated, and least indicative, criterion in the list. First, it should be emphasized that revenues from commissions and fees are extremely dissimilar from revenues from bid/ask spreads, to the extent that the latter can be seen as compensation. The allowance for bid/offer revenues in market making is one of the largest opportunities for abuse in the entire proprietary trading regulations. Regulators will be unable to monitor, verify, or enforce this rule in any meaningful way, and it is an enormous loophole through which much of the riskiest proprietary trading can and will occur. For an extensive discussion of this issue, please see part *a* of Question 85.

*5) Compensation Incentives*
Thoughtful and responsible compensation regimes will undoubtedly be one of the most important tools for affecting immediate and substantive improvements to the banking industry. Likewise, this requirement will present the greatest incentives to evade. We are pleased with the prominence of such compensation incentives within the structure of the Proposed Rule, but we have serious concerns with the degree of freedom that the Agencies allow banking entities in designing such regimes. It is unclear that the Agencies could collect sufficiently accurate or indicative data to reasonably measure or enforce the degree to which this requirement is met. We urge the addition of a clear explanation of how such a compensation design must be structured, with specific requirements to ensure the practicality of quality enforcement.

All compensation incentives must be, at the very least, based on a metric that meaningfully and responsibly accounts for the risk underlying profitability. Rewarding pure Profit and Loss ("P&L"), without consideration for the risk that was assumed to capture it, is a specific and identifiable characteristic of an arrangement that incentivizes proprietary risk taking. Conversely, incentives that are clearly based on customer satisfaction and prudent risk management will generally be consistent with, and serve to promote, the intentions of the statute.

One method to effectively "weight" revenue with respect to risk could be setting a maximum compensation when the trader's VaR is 0, with a sliding scale that decreases pay as VaR increases. The customer service component is measurable in many ways, including taking qualitative surveys of clientele in a manner similar to the exhaustive surveys by independent consultants that are commissioned regularly by banking entities. Presumably, in the absence of prospective proprietary trading profits, banking entities will be re-evaluating their business structure to ensure that market-making is in fact a valuable customer service, and should develop systems to quantify and monitor the real value of each trader in this context.

It is important to emphasize that the skill-set that is valuable to a successful risk-taker is not the same skill-set that is valuable to a successful customer servicer. It is true that a shift in incentives will likely discourage skilled proprietary risk-takers from pursuing careers as market makers. The same shift, however, will encourage skilled customer servicers to join a field that has been long dominated by proprietary speculators. The suggestion that "talent" will flee banking entities as a result of this legislation is clearly not a sensible one.

The Supplementary Information and Appendix B Commentary serve to significantly water down the sentiment of the compensation requirement. For example, the Supplementary Information weakens the Rule [90] by adding the word "primarily"[91], and should be substantially re-written. The Commentary in Appendix B explains that some consideration of profitable hedging activities should be acceptable, which implicitly provides for inappropriate incentives.

For example, consider two market makers that trade similar products with a similar client base. At the end of a year, both traders have traded comparable volumes, received comparable ratings from their customers, and both have maintained negligible VaRs throughout the year. If trader A has made $1mm profit, and trader B is flat at the end of the year, it may be reasonable to conclude that trader A has captured this profit by conducting superior risk-management activities throughout the year. Viewed another way, any significant gains should be seen as potentially significant losses in a less agreeable environment, given that proper hedging will always limit both gains and losses of an underlying position. It could be determined that Trader A conducted a hedging strategy that exposed him to sufficient risk to enable $1mm profit (or loss). Further, the circumstances of such a simplified comparison will rarely exist in practice, and clear performance benchmarks will be difficult to establish. There is much wiggle room in this consideration, and we see great risk and little reward to explicitly allowing for it in the Commentary in Appendix B.

In consideration of technical issues, there is an inconsistency between the rule text and the Supplementary Information with respect to explanatory facts and circumstances. A footnote[92] in the Supplementary Information states the obvious fact that such facts and circumstances could not reasonably exist to explain compensation incentives that are inconsistent with the Proposed Rule. Acknowledgement of this fact should be made explicit in the rule text itself, which currently allows for explanatory facts and circumstances regarding all of the market making criteria, including compensation incentives. We have proposed significant improvements to the

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[90] Proposed Rule § _.4(b)(2)(vii) ("The compensation arrangements of persons performing the market making-related activities are designed not to reward proprietary risk-taking.").

[91] NPR at 68,872 (discussion of the sixth market making criterion, § _.4(b)(2)(vi)) ("[A] banking entity relying on the market making exemption ***should*** provide compensation incentives that ***primarily*** reward customer revenues and effective customer service, not proprietary risk-taking.") (emphasis added).

[92] *Id.* at 68,891 n.201 ( "The proposed commentary does not contemplate explanatory facts and circumstances for the compensation incentives factor, given that the choice of compensation incentives provided to trading personnel is under the full control of the banking entity.").

language of the Commentary in Appendix B, which we have submitted as an appendix to this letter.

*6) Consistency with Appendix B Commentary*
It is clear that much of this Proposed Rule has been based on the model of highly liquid exchange-traded equity markets. Although this is a great simplifying factor, it is a tremendously unrealistic one. The Commentary in Appendix B is an example of how this rule tends to account for only the most liquid and transparent markets (i.e., listed equities, U.S. Treasuries), and fails to accurately describe market making in most illiquid or OTC markets. We find this particularly troubling, given that this benchmark asset type was not considered to be a contributor to the most recent crisis, and is not expected to present significant opportunities to evade this rule. Illiquid markets were and continue to be havens of risky and irresponsible activity, yet they are largely forgiven throughout this rule. We will discuss these issues further in the Questions specifically referencing the Appendix B Commentary, and we have attached as an appendix an alternative Commentary that better reflects our concerns.

**Question 88. Is incorporation of concepts from the definition of "market maker" under the Exchange Act useful for purposes of section 13 of the BHC Act and consistent with its purposes? If not, what alternative definition would be more useful or more consistent?**

As we have mentioned in previous answers, it is clear that highly liquid exchange-traded equity markets were the model on which much of this Proposed Rule has been based. Although this is a great simplifying factor, it is a tremendously unrealistic one. Strict adherence of this definition effectively prohibits "market making" in OTC or illiquid markets.

Here we propose an alternative definition of market maker:

> *The term "market maker" means any registered specialist operating on a monitored, multilateral electronic trading facility who is required to hold himself out (by entering contextual and tradable two-sided quotations in a publicly available trading platform) as being willing to buy and sell such security for his own account on a regular and continuous basis.*

**Question 89. Is the proposed exemption overly broad or narrow? For example, would it encompass activity that should be considered prohibited proprietary trading under the proposed rule?**

The exemption is overly broad as a result of:

- The inclusion of, and many allowances for, Illiquid and OTC products.
  For further discussion, please see Question 85.

- Complete lack of penalties. For further discussion, please see Questions 80 and 81.

**Question 90. We seek commenter input on the types of banking entities and forms of activities that would not qualify for the proposed market-making exemption but that commenters consider to otherwise be market making. Please discuss the impact of not permitting such activities under the proposed exemption (e.g., the impact on liquidity).**

We can see no activities or entities that would be inappropriately disqualified from using this exemption.

**Question 91. Is the requirement that a trading desk or other organizational unit relying on the market-making exemption hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the relevant covered financial position for its own account on a regular or continuous basis effective?**

This requirement is insufficiently clear. "A regular ***or*** continuous basis" allows a tremendous amount of freedom in interpretation, and lacks any real requirement that can be measured and monitored. It is important to keep in mind that it is possible to make a market outside of the prevailing market context, which would be untradeable in practice (since a higher bid or lower offer is available in the market). It would be possible for a market participant to make wide, out of context markets on a regular or continuous basis, with no real risk of execution. This participant could masquerade as a market maker, maintain access to important market information, trade only when it is advantageous to himself, and provide no liquidity to the market. Further, most markets lack structural frameworks that would provide any reasonable means of confirmation that this requirement is in fact being met.

**If not, what alternative would be more effective?**

For alternative language defining market maker, please see Question 88.

**Does the proposed requirement appropriately differentiate between market making-related activities in different markets and asset classes? If not, how could such differences be better reflected?**

For further discussion of this issue, please see Questions 85 and 88.

**Should the requirement be modified to include certain arbitrage trading activities engaged in by market makers that promote liquidity or price transparency, but do not serve customer, client or counterparty demands, within the scope of market making-related activity? If so why? How could such liquidity- or price transparency-promoting activities**

**be meaningfully identified and distinguished from prohibited proprietary trading practices that also may incidentally promote liquidity or price transparency?**

Arbitrage scenarios should absolutely ***not*** be included in this proposal. Executing arbitrage trades is one of the purest forms of principal proprietary trading in existence. In the event that an arbitrage scenario exists in such a way that it is inhibiting liquidity or transparency within a market, a market maker could certainly find a customer who would seek to benefit from it, and pass through such gains as a bonus in customer service. There is no reason a market maker should profit from arbitrage opportunities. Further, the practical definition of arbitrage has devolved to the point where extensive explanation would be required by the Agencies to address potential abuse in such a requirement. All activity that does not serve customers should be considered prohibited proprietary activity.

**Question 92. Do the proposed indicia of market making in liquid markets accurately reflect the factors that should generally be used to analyze whether a banking entity is engaged in market making-related activities for purposes of section 13 of the BHC Act and the proposed rule? If not, why not? Should any of the proposed factors be eliminated or modified? Should any additional factors be included? Is reliance on the SEC's indicia of bona fide market making for purposes of Regulation SHO under the Exchange Act and the equity securities market appropriate in the context of section 13 of the BHC Act and the proposed rule with respect to liquid markets? If not, why not?**

For liquid markets, the indicia are appropriate and consist of the most basic guidelines to be sufficient for the purposes of this Rule. No indicia should be removed from this list. It should be stressed that it should be largely unnecessary for any market maker to warehouse any significant risks for any period of time in liquid markets.

**Question 93. Do the proposed indicia of market making in illiquid markets accurately reflect the factors that should generally be used to analyze whether a banking entity is engaged in market making-related activities for purposes of section 13 of the BHC Act and the proposed rule? If not, why not? Should any of the proposed factors be eliminated or modified? Should any additional factors be included?**

As we have discussed at length in Question 85, market making in illiquid markets is extremely inconsistent with the Statute and the intentions of Congress, and should be removed from this rule.

We are very troubled by the inclusion of this "indicia differential" in the Supplementary Information, since it is not included in the text of the Proposed Rule. The Agencies have found that illiquid markets do not meet the requirements of bona fide market making, and so they have weakened the definition in order to include them. Despite the limitations of the above indicia for liquid markets, the definition of good and useful market making should not depend on the nature

of the market being made. If an illiquid market cannot the meet the requirements of this Rule, changes should be made within that market in an attempt to conform, or it should be considered prohibited activity.

We will outline our concerns for each of the illiquid indicia.

• *Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis.*
Regular, but intermittent and unactionable quotes do **not** in fact provide liquidity. This is a misunderstanding of how provision of liquidity is performed. At its best, indicative market information can provide transparency to a market (assuming the information is legitimately demonstrative of actual tradability). Transparency is an important quality to any market, but should not be confused with liquidity. It is possible to demonstrate true willingness and availability to provide liquidity by providing tradable markets in a publicly available and multilateral electronic trading facility.

• *With respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market.*
The removal of the requirement that such buying and selling must be in roughly similar size allows for significant accumulation of illiquid risk in the course of market making. This is an irresponsible indicia and should be amended to match the corresponding liquid indication.

• *Transaction volumes and risk proportionate to historical customer liquidity and investments needs.*
Unfortunately, most illiquid markets have no source for such historical risk and volume data. This is not a meaningful requirement without a centralized, market-wide repository of data upon which such a requirement could be based. Further, the historical liquidity and investment needs will be undifferentiable from the proprietary positioning that occurred before this rule is implemented.

***Illiquid markets should be held to the same indicia as liquid markets.*** These risky assets require more stringent oversight than liquid products, but are given significantly less in this rule.

**<u>Question 94</u>. How accurately can a banking entity predict the near-term demands of clients, customers, and counterparties?**

For an extensive discussion of this issue, please see Question 87, part 3.

Market makers trading liquid, exchange-traded products, as well as those market makers with an extremely firm grasp of their clients' investment objectives, trading patterns, and general near-term intentions, may have limited information with which to make general predictions of client

demand. These scenarios are *not* ubiquitous, and those circumstances that meet this criterion without constituting illegal front running are *dangerously few*. This is a nonsensical requirement with extremely dubious applications and the Agencies should seriously reconsider its place in this or any rule.

**Are there measures that can distinguish the amount of principal risk that should be retained to support such near-term client, customer, or counterparty demand from positions taken for speculative purposes?**

There are absolutely not any measures that indicate such an amount. Principal risk retention is *not* a requirement of true market making.

**How is client, customer, or counterparty demand anticipated in connection with market making-related activities, and how does such approach vary by asset class?**

See above.

**Question 95. Is the requirement that a banking entity relying on the market-making exemption be registered as a dealer (or in the case of a financial institution that is a government securities dealer, has filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act), or exempt from registration or excluded from regulation as a dealer under relevant securities or commodities laws effective? If not, how should the requirement be changed? Does the requirement appropriately take into account the particular registration requirements applicable to dealing in different types of financial instruments? If not, how could it better do so? Does the requirement appropriately take into account the various registration exemptions and exclusions available to certain entities, such as banks, under the securities and commodities laws? If not, how could it better do so?**

In a regulatory regime that imposes a specific definition of who is to be considered a market maker, it makes sense that entities that intend to provide such services be required to register as such. An industry-wide dealer registration process, in combination with a professional certification for individual market makers, would be simple and appropriate requirements.

**Question 96. Is the requirement that a trading desk or other organizational unit of a banking entity relying on the market-making exemption be designed to generate revenues primarily from fees, commissions, bid/ask spreads or similar income effective? If not, how should the requirement be changed? Does the requirement appropriately capture the type and nature of revenues typically generated by market making-related activities? Is any further clarification or additional guidance necessary? Can revenues primarily from fees, commissions, bid/ask spreads or similar income be meaningfully separated from other types of revenues?**

This requirement is ineffective. There is no practicable way to differentiate customer-driven trading revenues from proprietary gains when such customer revenues are in the form of bid/ask spreads.

Bid/ask spreads are unfortunately unavoidable, and should be sized appropriately with the necessary cushion a market maker requires to efficiently mitigate the assumed risks. These bid/asks should not be generating extraneous revenue, or else prohibited proprietary trading is taking place. This is a meaningless requirement in the vast majority of markets in which it will be employed.

For further discussion of this issue, please see Question 87, part 5.

**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?**

For an in-depth discussion of this issue, please see Question 87, part 6. We propose the following change to the language of § _.4(b)(2)(vii) of the Proposed Rule:

> The compensation arrangements of persons performing the market making-related activities ~~are designed not to~~ *do not* reward proprietary risk-taking.

Furthermore, in order to be consistent with the intentions of the statute, the explanation of this sixth criterion in the Supplementary Information should be changed to the following:

> Under § _.4(b)(2)(vii) of the Proposed Rule, the compensation arrangements of persons performing market making-related activities at the banking entity must ~~be designed~~ not ~~to~~ encourage or reward proprietary risk-taking. Activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position held in inventory, rather than success in providing effective and timely intermediation and liquidity services to customers, are inconsistent with permitted market making-related activities. ~~Although a banking entity relying on the market-making exemption may appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed principal risk retained, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not proprietary risk-taking~~.

**Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted market making-related activity?**

All compensation incentives must be, at the very least, based on a metric that meaningfully and responsibly accounts for the risk assumed in the process of making markets, as well as the quality of customer service conducted.

**Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?**

Rewarding trading profits of any kind, or any reference to budgets or profit targets, would be specific identifiable characteristics of prohibited incentives.

**Question 98. Is the inclusion of market making-related hedging transactions within the market-making exemption effective and appropriate?**

We see the potential for an enormous amount of confusion due to this inclusion. We believe it would be much more straightforward for client-facing market making trades to be included in the Market Making exemption, and other hedge-related trades to be appropriately included in the Risk-Mitigating Hedging exemption. This will assist the Agencies in clearly distinguishing between explicit client-related activity, and other potentially evasive hedging activity. Our specific concerns with respect to the hedging exemption will be addressed in the questions for that section.

**Are the proposed requirements that certain hedging transactions must meet in order to be considered to have been made in connection with market making-related activity effective and sufficiently clear? If not, what alternative requirements would be more effective and/or clearer? Should any of the proposed requirements be eliminated? If so, which ones, and why?**

We find it unclear as to the specific advantage to claiming a specific hedging activity fell under the market-making exemption as opposed to the general risk-mitigating hedging exemption.

**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 need to identify and quantify which trades are in fact customer servicing and "customer-initiated"[93] is central to the implementation of this Rule. This can only be sensibly accomplished with a clear and specific definition of customer.

The Proposed Rule tends to group *customer* with the terms *client* and *counterparty*, and would implicitly or explicitly treat trades between banking entities as legitimate market making activity. In theory, a banking entity could establish a market making business that consists exclusively of trades "with the street" through inter-dealer brokers. Clearly, this scenario does not fit the description of the "customer service" that Congress sought to protect and exempt. Intermediating between two banking entities that neither request nor require such intermediation provides no added liquidity or efficiency to a market. We concede that such street trading may serve a liquidity function by availing the capacity to hedge the risks borne of legitimate client trades, but if a trade with another covered banking entity is conducted for the purposes of risk-mitigating hedging, it should be demonstrable as such and consistent with the guidelines for the Risk-Mitigating Hedging exemption.

The presumption underlying the market making exemption is that banking entities provide a variety of financial services to their client base, and market making is an essential facet of a holistic business. In this case, it should be easy to demonstrate an existing pattern of mutually beneficial business activities, outside of market making, with any customer for the purposes of this definition. Additionally, it is clear that the services provided by a banking entity are sufficiently well-known that an appropriate customer base is willing and able to initiate a relationship with a banking entity in the absence of direct or indirect solicitation. The Agencies should require that relationships are pre-existing and customer-initiated in order to qualify as customers with respect to this exemption.

Relationships that are "indirect" should **never** be considered legitimate customer relationships. The inclusion of "indirect" customer relationships would dilute this Rule and render it ineffective. The inclusion of indirect relationships would define a banking entity's customer base to include all direct customers, customers of their direct customers, and all iterative extensions of such. The explicit differentiation between direct and indirect, as well as the explicit exclusion of Indirect from the definition of customer, is essential.

We urge the Agencies to consider that banking entities will undoubtedly seek to benefit from broadening their "customer" base, through which they are able to make use of the applicable exemptions within this Rule. When considered in combination with the absence of "bright-line" prohibitions of risky activities, this Rule may incentivize improper solicitation of customers by banking entities.

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[93] FSOC Study, *supra* note 54, at 3.

Finally, the FSOC specifically calls for the Proposed Rule to explicitly define the characteristics of a client, and these factors (direct vs. indirect relationships, nature of initiation) should be considered central to such a definition. We propose the following definition of "customer, client, or counterparty" to be used throughout the Proposed Rule:

> *A customer is a counterparty that is NOT itself a covered banking entity, and with which a banking entity has a direct and substantive relationship, which was initiated by the client prior to the transaction.*

For the purposes of the Market Making exemption, "client" and "counterparty" should be removed from the language of the rule, and it is critical to the intention of the Rule that the term "customer" be well-defined.

**Question 100. Are there other types of market making-related activities that should also be included within the scope of the market-making exemption? If so, what additional activities and why? How would an exemption for such additional activities be consistent with the language and intent of section 13 of the BHC Act? What criteria, requirements, or restrictions would be appropriate to include with respect to such additional activities? How would such criteria, requirements, or restrictions prevent circumvention or evasion of the prohibition on proprietary trading?**

No. The current exemption for market making is far too broad as it stands. It would be irresponsible to extend the exemption in any way from its current form.

**Question 101. Do banking entities currently have processes in place that would prevent or reduce the likelihood of taking speculative, proprietary positions in the context of, or mischaracterized as, market making-related activities? If so, what processes?**

Since a model of maximizing profitability has been the standard, it would be unreasonable to assume that processes to limit such activity would ever exist in the absence of regulation.

**Question 102. Is the proposed rule's approach to implementing the hedging exemption effective? If not, what alternative approach would be more effective?**

The hedging exemption is ineffective as it applies to derivatives and other structured products. The complicated risk profile of such products calls for a variety of piecemeal hedge trades for each component risk, all of which can present new exposures that then need to be hedged by more piecemeal trades. The resulting trading book quickly becomes a complicated web of trades that are increasingly difficult to adequately unwind.

**Question 103. Does the proposed multi-faceted approach appropriately take into account and address the challenges associated with differentiating prohibited proprietary trading**

**from permitted hedging activities? Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?**

The proposed multi-faceted approach takes into account some, but not all of the challenges associated with differentiating prohibited from permitted activity. Specific additional considerations are outlined in the following questions, but in general we see this particular exemption as far too complicated to enact with any degree of effectiveness. Illiquid products often have no appropriate hedges, and are irresponsibly managed through a series of imperfect trades that each present new exposures in need of mitigation. Derivatives require a similar process of piecemeal "hedge" construction. Within even the most basic portfolio will exist ample opportunity to disguise proprietary activity, and we are discouraged by the dearth of meaningful improvements that can be made to this rule. Prohibiting market making in illiquid securities and OTC derivatives would be an obvious improvement, but as long as they remain permitted we see the risk-mitigating hedging exemption as a failure.

**Question 104. Does the proposed approach to implementing the hedging exemption provide banking entities and market participants with sufficient clarity regarding what constitutes permitted hedging activities? If not, how could greater clarity be provided?**

The extent to which a given trade can be designated as an appropriate hedge of any other trade becomes less clear as the product in question becomes less liquid. To provide greater clarity, the Agencies could:

- Prohibit market making in assets with complicated risk profiles (e.g., OTC derivatives, Fixed Income, other illiquid positions, etc.).

- Explicitly limit the universe of acceptable hedges to those that are universally understood as appropriate for a given product.

**Question 105. What impact will the proposed approach to implementing the hedging exemption have on the hedging and risk management activities of a banking entity and the services it provide to its clients? If any of these impacts are positive, how can they be amplified? If any of these impacts are negative, how can they be mitigated?**

The impact of this approach on banking entities and their client service will be minimal. However, it is easy to imagine that the complicated web of partial hedges, as allowed by the Rule, will be extremely difficult to effectively monitor and regulate. Much of this resulting burden, of course, will be borne by the Agencies as they attempt to identify evasion in this process. This negative impact can be somewhat mitigated in the following ways:

- Impose strict limits on what constitutes an appropriate hedge, with anything less than full or complete hedging discouraged or prohibited. This will significantly simplify the resulting risk profile of every hedged trade.
- Require that each type of exposure (Counterparty, Market, Inflation, Interest Rate, etc.) be designated exclusively as hedged individually, or in aggregate. Requiring risk factors to be hedged at multiple levels is irresponsible and complicating.
- Develop and maintain a database of appropriate and qualifying hedging products for each asset.

**Question 106. What burden will the proposed approach to implementing the hedging exemption have on banking entities? How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?**

We encourage the Agencies to require much more robust reporting requirements for all trades seeking to rely on this exemption. For further discussion of this issue, please see Question 114.

**Question 107. Are the criteria included in the hedging exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other requirements be added?**

The criteria in this exemption are necessary, but insufficient to be truly effective. Discussions and suggestions for the improvement of each criteria will be included in the following questions.

**Question 108. Is the requirement that a transaction hedge or otherwise mitigate 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 banking entity effective?**

The Proposed Rule requires a tremendous amount of additional clarity with respect to reasonable, regulated hedging policies.

The Rule text in § _.5(b)(2)(ii) requires that a transaction:

> [h]edge[] or otherwise mitigate[] 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;

The inclusion of "basis risk" raises several serious concerns. First, there is no definition of basis risk in the Proposed Rule. This is a serious omission, given that basis risk is generally understood as the risk that two assets move inconsistently with each other. Basically, a basis risk exists between any two assets at all times, and should not be considered an appropriate type of hedge under this exemption, absent extensive further clarification.

In its explanation of § _.5(b)(2)(iv), the Supplementary Information indicates that basis risk is intended to reference the imperfection of a hedge, and implies that basis risk (like counterparty risk) is an exposure that need not be exhaustively mitigated in market-making operations:

> However, the proposal also recognizes that any hedging transaction will inevitably give rise to certain types of new risk, such as counterparty credit risk or **basis risk reflecting the differences between the hedge position and the related position**; the proposed criterion only prohibits the introduction of additional significant exposures through the hedging transaction.

We see enormous potential for evasion of this Rule by designating any proprietary exposure as a "basis risk," thereby subjecting the exposure to the hedging exemption. For instance, it seems that a banking entity could simply take a proprietary position by hedging half of an offsetting market making exposure, and designating the other half as a "basis risk" to the degree that the hedge does not fully mitigate the underlying trade.

Furthermore, proper and diligent hedging of derivatives will generally involve one primary hedging transaction, followed by exclusively basis hedges as secondary exposures require dynamic hedging. Therefore, it is expected that "basis risk" hedging will comprise the majority of all hedging-related activities in many products, and a robust and specific definition and explanation of this risk is essential.

**If not, what requirement would be more effective?**

We suggest the explicit removal of "basis risk, or similar risks" from this criteria. Additionally, a specific requirement that each type of exposure be designated as one that is hedged exclusively on an individual or an aggregate basis is essential.

**Does the proposed approach sufficiently articulate the types of risks that a banking entity typically hedges?**

There are many other risks that are not accurately addressed in this exemption as they are difficult to hedge in practice without exposure to other risks. Notable among these are:

Default Risk: Hedging default risk typically involves buying/selling short-term protection on a rolling basis as longer-dated contracts expire. Significant short-term credit risks must be assumed in order to hedge this rolling default risk. Default risk also serves to highlight the practical impossibility of effective hedging of derivatives transactions. This is one of many reasons we encourage the Agencies to prohibit all derivatives and illiquid market-making activities.

Liquidity Risk: This is the most glaring absence from the risk considerations in this Proposed Rule. Adequately preparing for the often significant changes in risk profile that occur in illiquid markets is the single most important preventative measure a bank can take to ensure that disruptive events do not turn into systemic collapses. The failure to do so was a primary cause of the recent financial crises,[94] and this should be a primary focus of all risk management procedures in a post-crisis world. The most effective way to hedge against liquidity risk is to limit inventories such that they are proportional to the relative illiquidity of the product.

**Does the proposal sufficiently address application of the hedging exemption to portfolio hedging strategies? If not, how should the proposal be changed?**

No. A specific requirement that each type of exposure be designated as one that is hedged exclusively on an individual or an aggregate basis is essential. Risks should never be hedged on both an individual and aggregate basis, and most risk types are appropriately mitigated in only one of the categories. For instance, counterparty risk should always be (and in practice, typically always is) mitigated on a portfolio basis, and individual traders should not be able to make use of the hedging exemption by claiming mitigation of such a risk. For additional discussion of this issue, please see Question 109.

**<u>Question 109</u>. Does the manner in which section __.5 of the proposal would implement the risk-mitigating hedging exemption effectively address transactions that hedge or otherwise mitigate specific risks arising in connection with and related to <u>aggregated</u> positions, contracts, or other holdings of a banking entity? Do certain hedging strategies or techniques that involve hedging the risks of aggregated positions (e.g., portfolio hedging) (i) create the potential for abuse of the hedging exemption or (ii) give rise to challenges in determining whether a banking entity is engaged in exempt, risk-mitigating hedging activity or prohibited proprietary trading? If so, what hedging strategies and techniques, and how? Should additional restrictions, conditions, or requirements be placed on the use**

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[94] *See* Garry J. Schinasi, *Safeguarding Financial Stability: Theory and Practice* 214 (International Monetary Fund 2005) ("Market participants acknowledge their previous failures to realize the importance of liquidity risk in OTC derivatives, and that the capacity to manage it is still in an embryonic stage. One common mistake in 1998 was that risk management systems assumed markets would remain liquid and price changes would follow historical norms. Risk managers also failed to engage in stress testing to examine the implications of severe liquidity problems. Few firms were, for the purposes of risk management, marking credit exposures to estimated liquidation values instead of to current market values.").

**of the hedging exemption with respect to aggregated positions so as to limit potential abuse of the exemption, assist banking entities and the Agencies in determining compliance with the exemption, or otherwise improve the effectiveness of the rule? If so, what additional restrictions, conditions, or requirements, and why?**

We are alarmed by the focus on "portfolio hedging" throughout the Risk-mitigating hedging exemption. We interpret the intent of this exemption as relating to Delta One or central execution desks that have become ubiquitous across banking entities in recent years. Certainly these central hedging operations pose significant risks, as famously exemplified in the rogue trading scandal that caused a $2.3 billion loss in 2011.[95] While it is clear that such practices necessitate increased oversight and significantly improved risk-management procedures, there are other instances of aggregated hedging that will be inappropriately included within "portfolio hedging" that require consideration. Even outside of central execution desks, many risks are currently managed on an aggregated basis, due to the numerous, and often compounding, proprietary portfolios that exist on every market making desk of every covered banking entity. With so many independent strategies at play, it is not uncommon for large exposures across a variety of assets to result when they are combined in the view of a manager. Management will often make use of a "back book" or "management book" for the dual purposes of conducting broad-line hedges against lumpy trading-desk exposures, ***and*** taking proprietary positions that fall outside of the mandate or risk limits of an individual trader. While it is expected that such obvious proprietary exposures will diminish with the implementation of this Rule, we fail to understand the continued relevance of most management hedging operations once individual trading books pare their component exposures. **We are troubled by the potential for such "back books" to become havens of prohibited proprietary activity after the implementation of this Rule.**

A specific requirement that each type of exposure be designated as one that is hedged exclusively on an individual or an aggregate basis is essential. Risks should never be hedged on both an individual and aggregate basis, and most risk types are appropriately mitigated in only one of the categories. For instance, counterparty risk should always be (and in practice, typically always is) mitigated on a portfolio basis, and individual traders should not be able to make use of the hedging exemption by claiming mitigation of such a risk. These risks can be managed by a level of organization that is out of touch with the day-to-day operations of a trading desk. We propose that the Agencies consider requiring banking entities to create central "Risk Management" groups to perform aggregated hedges.

The broad allowance for aggregated hedging is troubling and its exemption is inconsistent with the intentions of this Rule. This rule mandates strict risk mitigation at a micro level, and should remove all implicit or explicit allowances for the dangerous practice of management hedging.

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[95] Frank Jordans, *UBS Rogue Trader Losses Reach $2.3 Billion, CEO Not Resigning*, Huffington Post, Sep. 18. 2011. http://www.huffingtonpost.com/2011/09/18/ubs-rogue-trader-losses_n_968491.html.

More generally, a banking entity's need for substantive aggregated hedging is indicative of a failure to appropriately mitigate risks at lower levels within an entity, and is therefore in violation of the spirit of the Rule. We acknowledge that the statute allows for aggregated hedging in Section 619(d)(1)(C)[96], and we hope that the Agencies are prepared to be diligent in monitoring this activity closely to discourage abuses, which we see as a serious risk.

**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?**

It would be disingenuous to presume that there is not broad agreement by traders about which products are appropriately correlated hedges for their own books. Those assets that are appropriate hedges for any given transaction are widely known and accepted throughout its market; they comprise a limited universe. There should exist a central database that catalogues those hedges that are consistently appropriate for each product, as this will eliminate confusion and flexibility about what is considered to be "reasonably correlated" for the purposes of this exemption. The only indication of what is intended as "reasonable" comes from the Supplementary Information of the Proposed Rule:

> A transaction that is only tangentially related to the risks that it purportedly mitigates would appear to be indicative of prohibited proprietary trading.[97]

We understand this to mean that the Agencies define "reasonable" as somewhere between tangentially related and perfectly offsetting. This is an unworkably broad definition. It is, of course, not uncommon for correlation to exist among a variety of semi-related financial instruments. Increasingly, banks are developing sophisticated hedging algorithms to determine the cheapest hedge that satisfies correlation inputs, leading to decreased reliance on common-sense oversight.[98] The degree of correlation, horizon over which the correlation exists, and circumstances causing the correlation to exist are important considerations that are undermined by the inclusion of the word "reasonably."

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[96] 12 U.S.C. § 1851(d)(1)(C). *See also* Proposed Rule § _.5(b)(2)(ii) ("Hedges 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").

[97] NPR at 68,875 (discussion of § _.5(b)(2)(iii)).

[98] *See* Izabella Kaminska, *Rise of the Central Execution Desk*, FT Alphaville, Oct. 4, 2011, http://ftalphaville.ft.com/blog/2011/10/04/692511/rise-of-the-central-execution-desk/ ("Since no bank is naturally privy to perfectly balanced flows, it's increasingly becoming the role of quant teams to identify cheaper hedging alternatives which happen to work just as well as hedging with like-for-likes. This applies to both banks' internal 'matching' strategies as well as to what instruments they use for hedging their net positions in the wider market. It's also one reason cross-asset trading has also become so popular.").

We would like to urge the Agencies to exercise caution in their assessment of the appropriateness of certain hedges. Many products can be manipulated such that they artificially assume a reasonable correlation that is based on purely technical, rather than fundamental factors. A common practice in illiquid markets, for instance, is for traders to adopt some unrelated but comparatively cheap asset as a "hedge" for their product. With enough sponsorship, such a proxy hedge can abandon its own fundamentals and adopt the technical qualities of that asset that it is meant to hedge. In times of stress, this artificial correlation can break down quickly and turn a hedged position into two naked exposures. This is a dangerous but common practice that should not be permitted within this Rule's hedging exemption, but will require thorough supervision to prevent. A hedge reduces exposure, or else it is not, by definition, a hedge. This point is of great concern to us.

Good hedges will always be able to meet strict requirements, and the Agencies should insist that they will not allow for inappropriate flexibility in this exemption. The current hedging requirement will lead to extremely complicated risk profiles as banking entities increasingly rely on the cheapest satisfactory hedge, and go on to further hedge the extraneous exposures that result from such imperfect hedging.

**If not, how should the requirement be changed?**

The basis of "reasonable correlation" to determine an appropriate hedge should be removed. Those assets that are appropriate hedges for any given transaction are known and agreed upon throughout its market. It would serve the Agencies to maintain a database of qualifying hedges by product in order to assist the monitoring process. Banking entities should not be allowed to retroactively claim that an abnormal or unusual asset happened to meet this rule's overly-vague criteria and so qualifies as a permitted hedge.

**Should some specific level of correlation and/or hedge effectiveness be required? Should the proposal specify in greater detail how correlation should be measured?**

It would be disingenuous to presume that traders are unable to identify those products that would or would not behave as appropriate, correlated hedges for their own books. As mentioned above, there should exist a central database that catalogues the hedges that are consistently appropriate for each product. The Agencies should be prepared to prohibitively penalize violations.

**Should the proposal require hedges to be effective in periods of financial stress?**

Yes. This is one of several improvements that would lead to higher quality hedges, and simpler resulting risk profiles. Hedges that are truly appropriate will indeed satisfy this requirement. In the absence of such a requirement, the current hedging requirement will lead to extremely complicated risk profiles (as banking entities begin relying on the cheapest satisfactory hedge,

and go on to further imperfectly hedge their hedges, etc.). This kind of forward-looking requirement encourages responsibility and complicates attempted evasion.

**Does the proposal sufficiently reflect differences in levels of correlation among asset classes? If not, how could it better do so?**

As stated above, the understanding of a truly appropriate hedge for a given product is generally consistent industry wide, and attempts to rely on this exemption by unorthodox strategies should be considered suspicious. It should be the responsibility of the trader to demonstrate to the Agencies that a specific level of correlation is indeed appropriate.

**Question 111. Is the requirement that the transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction effective?**

This requirement is necessary but insufficient to beget meaningfully responsible hedging activity. This requirement should extend throughout the life of the hedge, not merely at the inception.

**Does the requirement establish an appropriate range for legitimate hedging while constraining impermissible proprietary trading?**

No. This requirement establishes an irresponsibly broad range for legitimate hedging that provides for extensive impermissible proprietary trading.

**Is this requirement sufficiently clear? If not, what alternative would be more effective and/or clearer?**

As discussed in more detail in Question 110, we suggest a central database of appropriate hedges per product.

**Are there types of risk-mitigating hedging activities that may give rise to new and significant exposures that should be permitted under the hedging exemption? If so, what activities?**

No. Such activities do not, and cannot, exist. This question seems to suggest that there are some risks that are seen to be by the Agencies as "good" or "harmless." This is a very dangerous concept to introduce in a regulatory context, and we foresee many dangerous implications from the industry viewing certain kinds of exposures as benevolent or inconsequential to regulators.

**Should the requirement that no significant exposure be introduced be extended for the duration of the hedging position? If so, why?**

*Absolutely*. Without this requirement, the hedging exemption would be nonsensical. The continuous dynamic management of risks in all markets, with particular importance in all derivatives markets, is absolutely the most important factor in responsible risk management. What is an effective hedge today can easily become a doubling-down tomorrow, and this effect is multiplied as illiquidity and volatility rise. Failing to extend this requirement implicitly allows every kind of proprietary exposure to exist in a portfolio, under the guise of the risk-mitigating hedging exemption.

Imagine a situation where a regulator finds a large troublesome exposure in the book of a market maker, who explains that the exposure arose from a legitimate hedge to a trade he did a few years ago. This situation could (and likely will) occur in every product across every banking entity.

This extension would significantly improve the current language in § _.5(b)(2)(v)(iii), which requires the continual review, monitoring, and management of a transaction relying on this exemption to "mitigate any significant exposure arising out of the hedge after inception." Prohibiting the use of a "hedge" that could introduce such an exposure would lead to higher quality hedging, and simpler resulting risk profiles.

**Question 112. Is the requirement that any transaction conducted in reliance on the hedging exemption be subject to continuing review, monitoring and management after the transaction is established effective? If not, what alternative would be more effective?**

This is an incredibly important and crucial element of the hedging exemption. The vast majority of markets, particularly derivatives markets, require constant and robust dynamic risk management. The absolute necessity of this requirement stems from the Rule's failure to require exactly offsetting trades to be considered a hedge. What is an effective hedge today can easily become a doubling-down tomorrow, and this effect is multiplied as illiquidity and volatility rise.

In the absence of this requirement, it would be possible for a trader to take advantage of a momentary correlation between assets to designate a "hedge" today that will in fact be a proprietary position tomorrow.

**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? Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted risk-mitigating hedging activity? Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?**

Thoughtful and responsible compensation regimes will undoubtedly be one of the most important tools for effecting immediate and substantive improvements to the banking industry. Likewise, this requirement will present the greatest incentives to evade. We are pleased with the prominence of such compensation incentives within the structure of the Proposed Rule, but we have serious concerns with the degree of freedom that the Agencies allow banking entities in designing such regimes. It is unclear that the Agencies could collect sufficiently accurate or indicative data to reasonably measure the degree to which this requirement is met. We urge the addition of a clear explanation of how such a compensation design must be structured, with specific requirements to ensure the practicality of quality enforcement.

All compensation incentives must be, at the very least, based on a metric that meaningfully and responsibly accounts for the risk underlying profitability. Rewarding pure P&L, without consideration for the risk that was assumed to capture it, is a specific and identifiable characteristic of an arrangement that incentivizes proprietary risk taking. Conversely, incentives that are clearly based on customer satisfaction and prudent risk management will generally be consistent with, and serve to promote, the intentions of the statute.

One method to effectively "weight" revenue with respect to risk could be setting a maximum compensation when the trader's VaR is 0, with a sliding scale that decreases pay as VaR increases. The customer service component is measurable in many ways, including taking qualitative surveys of clientele in the manner similar to the exhaustive surveys by independent consultants that are commissioned regularly by banking entities. Presumably, in the absence of prospective proprietary trading profits, banking entities will be re-evaluating their business structure to ensure that market-making is in fact a valuable customer service, and should develop systems to quantify and monitor the real value of each trader in this context.

For further discussion of this issue, please see Question 97.

**If not, how should the requirement be changed?**

In the absence of a very specific set of guidelines imposed on banking entities as we describe above, we propose the following changes to the current language of the NPR:

> Seventh, § _.5(b)(2)(vi) of the Proposed Rule requires that the compensation arrangements of persons performing the risk-mitigating hedging activities ~~are designed~~ *do* not ~~to~~ reward proprietary risk-taking. Hedging activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position, rather than success in reducing risk, are inconsistent with permitted risk-mitigating hedging activities.

**<u>Question 114</u>. Is the proposed documentation requirement effective? If not, what alternative would be more effective?**

The documentation requirement in the Rule applies only to hedges established by managers, not the specific market makers that also intend to rely heavily on the risk-mitigating hedging exemption. Any applicable documentation can be easily and quickly produced by traders, if they are in fact conducting a trade with a specific hedge in mind, as is required. The implication, then, is that market makers need only provide a post-hoc explanation for a trade's reliance on this exemption, which (given the enormous scope of related risks allowed in the Rule) will be easy to abuse. We urge the Agencies to remove all references to "levels of organization" in the language of § _.5(b), as the necessity for compliance is irrespective of seniority. We propose the amendment of the wording of § _.5(c) to the following:

> § _.5(c) Documentation. With respect to any purchase, sale, or series of purchases or sales conducted by a covered banking entity pursuant to this § _.5 for risk-mitigating hedging purposes ~~that is established at a level of organization that is different than the level of organization establishing or responsible for the positions, contracts, or other holdings the risks of which the purchase, sale, or series of purchases or sales are designed to reduce~~, the covered banking entity must, at a minimum, document, *with particularity,* at the time the purchase, sale, or series of purchases or sales are conducted risk-mitigating purpose of the transaction and identify the risks of the individual or aggregated positions, contracts, or other holdings of a banking entity that the transaction is designed to reduce.

**Are there certain additional types of hedging transactions that should be subject to the documentation requirement? If so, what transactions and why? Should all types of hedging transactions be subject to the documentation requirement? If so, why?**

All hedging should be subject to the documentation requirement, because any "hedge" can potentially be a prohibited proprietary trade, and the Agencies must be able to clearly identify which trades were conducted for which purposes. The onus must be on the banking entities to prove that their activities are within the bounds of the permitted activities in this Proposed Rule. Those trades for which a banking entity is unable to do so must be considered prohibited proprietary activity.

**Should banking entities be required to document more aspects of a particular transactions (e.g., all of the criteria applicable to § _.5(b) of the proposed rule)? If so, what aspects and why? What burden would the proposed documentation requirement place on banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?**

As a group that includes former traders, we feel that it is important to emphasize that traders are typically intimately aware of their risk profiles at all times, and the impact of trades they conduct. If a trader does not have time to jot down a few known details of a given trade, the Agencies can be assured that he has not adequately thought through the impacts of the trade, which consequently cannot be considered a legitimate risk-mitigating hedge.

Here we will propose an example of responsible documentation requirements: Each trade should explicitly note which specific risk it is intended to hedge. If it is an exactly offsetting trade (i.e., a bond sale to hedge a previous purchase of the same bond), the trader must write down the approximate current risks in that asset (e.g., Duration, Treasuries, etc.), and the approximate offset that will be caused by the given hedge. These running-total approximations, then, should match the asset's official intraday risk at all times, which can be easily confirmed by regulators. If it is an imperfectly offsetting trade (i.e., a bond sale to hedge a previous CDS sale), the trader must write down the approximate current risks in **both** assets (DV01, IR risk, bond risks, etc.), the approximate offset that the trade will provide in the applicable risk type(s), **and** the new risks caused by the imperfect hedge (e.g., basis risk, treasury risk, etc.).

It will undoubtedly be argued that this is an impossible requirement for traders to document with each trade, due to the fast-moving nature of their business. This is patently untrue. Traders have always, of course, found time to record the execution details of every trade at the time of execution, and the requirements above will add only a few more keystrokes to an already streamlined process. All competent traders necessarily have the relevant approximations in mind for every trade all day long, and any trader who claims that such requirements take too much time should be seriously examined for competency in his product. This set of requirements is a simple and meaningful way to ensure that all trades indeed have a permitted and deliberate intention at the time of execution, and provides regulators and managers with a real-time, intuitive way to monitor compliance. Automation and increased reliance on electronic platforms will also serve to ease time requirements and increase accuracy of such data. This type of requirement has the added benefit of encouraging traders to focus on maintaining an accurate and responsible understanding of their risks as such risks evolve throughout the day. Extensive additional documentation requirements are necessary to achieve compliance with the Proposed Rule. The "burden" of quickly committing known information to paper or database is both negligible and essential for the proper implementation of the Rule.

**<u>Question 115</u>. Aside from the required documentation, do the substantive requirements of the proposed risk-mitigating hedging exemption suggest that additional documentation would be required to achieve compliance with the proposed rule? If so, what burden would this additional documentation requirement place on banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?**

As discussed in Question 114 above, extensive additional documentation requirements are necessary to achieve compliance with the Proposed Rule. The "burden" of quickly committing known information to paper or database is both negligible and essential for the proper implementation of the Rule.

It is our hope that the Proposed Rule will encourage banking entities to pay greater attention to risk profiles, and promote a more holistic and responsible approach to risk management throughout the industry. We see this increased diligence as a benefit, not a burden, regardless of the amount of paperwork it may necessitate.

**Question 116. Is the proposed rule's approach of identifying which of the statutory exemptions contained in section 13(d)(1) of the BHC Act apply to the proposed rule's proprietary trading provisions effective and/or consistent the language and purpose of the statute? If not, what alternative would be more effective and/or consistent with the language and purpose of the statute?**

The four "other permitted trading activities" appear to be those that apply to proprietary trading, consistent with the statute.

It is worth reiterating that the exemption of repurchase and reverse repurchase agreements is inappropriate and in conflict with the intentions of the statute. We discuss this issue at greater length in Question 30.

**Question 117. Are there statutory exemptions that should apply to the proposed rule's proprietary trading provisions that were not included? If so, what exemptions and why?**

No. Everything in the statute is accounted for.

**Question 118. Are there statutory exemptions that were included in the proposed rule's proprietary trading provisions that should not have been included? If so, what exemptions and why?**

We recognize that the Agencies have incorporated all possible statutory exemptions into the Proposed Rule.

**Question 119. Is the proposed rule's application to trading in government obligations sufficiently clear? Should such obligations expressly include, for example, instruments issued by third parties but insured or guaranteed by an enumerated government entity or otherwise backed by its full faith and credit?**

The Proposed Rule's application to trading in government obligations is consistent with the statutory language and accurately reflects Congressional intent. However, the Agencies' treatment of municipal bonds can be ameliorated.

We applaud the Agencies for confirming that the statutory phrase "an obligation issued by any State or political subdivision thereof"[99] does **not** include the obligations of an agency of any State or political subdivision thereof. However, we question why this important clarification was relegated to a footnote.[100] This is a significant distinction that should be made explicit in the body of the regulation itself, to emphasize to reviewing courts, compliance officers, Agency staff, and others that municipal agency bonds do not benefit from an exclusion from the Volcker Rule.

Further, it behooves the Agencies to recognize that non-agency municipal bonds, while excluded under the statute, warrant extra regulatory vigilance. Municipal bonds are often risky investments, especially as compared to debt issued at higher levels of government, such as the state or federal level. Indeed, we suspect that many municipal bonds would fail under the "risky assets" backstop. As discussed below, the Agencies should require an interpretive determination by the Federal Reserve before a banking entity is allowed to trade in municipal bonds.

**Question 120. Should the Agencies adopt an additional exemption for proprietary trading in State or municipal agency obligations under section 13(d)(1)(J) of the BHC Act? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?**

The Agencies should *not* adopt an additional exemption for proprietary trading in State or municipal agency obligations under Section 13(d)(1)(J) of the BHC Act, as doing so would be conflict with Section 13(d)(1)(J)'s mandate to promote and protect the safety and soundness of banking entities and the financial stability of the United States. We remind the Agencies that, as per Congressional intent, Section 13(d)(1)(J) "sets an extremely high bar."[101]

Congress had the explicit opportunity to craft a municipal ("muni") agency bond exemption, and declined to do so, despite the exhortations of the banking lobby. Therefore, the Agencies should recognize this as a clear signal against the usage of their authority under Section 13(d)(1)(J) for this purpose.

Municipal bonds issued by state agencies and quasi-governmental authorities should NOT be exempted because they pose obvious risks to the banking system. The market for these bonds has not been properly regulated or controlled. In general, bankers have been able to exert too

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[99] 12 U.S.C. § 1851(d)(1)(A).
[100] *See* NPR at 68,875 n.165.
[101] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

much influence over municipal issuance. Banks own about half the bonds issued by municipal authorities,[102] and hold inordinate, unfettered and anti-competitive sway over such issuing authorities. The recent Wells Fargo muni debacle serves as a clarion example of the lack of effective regulation in the municipal bond market. Wells Fargo & Co. ("WF") agreed to pay $148 million to settle criminal charges and civil claims for conspiring to overcharge state and local governments on investments.[103] Essentially, WF fraudulently rigged the bidding for investment deals with local governments on at least 58 transactions from 1997 through 2005.[104] The settlement is the latest in a more than five-year investigation into how Wall Street banks conspired with local-government financial advisers to wangle excessive fees on investment deals by rigging auctions and carving the market up among themselves. J.P. Morgan Chase & Co., UBS AG and Bank of America Corp. previously settled similar cases.[105]

Other examples of bank misconduct in the muni sector abound, as the Agencies are doubtless aware. Stated plainly, an additional exemption for municipal agency bonds would be harmful to the banking system, as it would encourage banks to continue (and refocus) their attention on remote, highly unregulated markets in quasi-governmental securities that are already rife with abuse.

Further, an additional exemption for municipal agencies would strengthen the muni market, which encourages reckless state spending and reduces tax revenues. States across the U.S. have teetered on the edge of default because of inordinate bond issuances. California is a perfect example. California has nearly defaulted on its bonds and as a result has had to increase taxes and tuition, and cut back on services for residents. California is estimated to hold an approximate $25 billion dollar deficit, and some commentators expect the State's credit "to go from bad to terminal."[106]

**<u>Question 121</u>. Should the Agencies adopt an additional exemption for proprietary trading in options or other derivatives referencing an enumerated government obligation under section 13(d)(1)(J) of the BHC Act? For example, should the Agencies provide an exemption for options or other derivatives with respect to U.S. government debt obligations? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?**

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[102] Alex Dunnin. *Volcker Rule Dramatics Continue*, Financial Standard Online, Nov. 23, 2011. http://www.financialstandard.com.au/news/view/12506675/.
[103] Michael B. Marois & Brendan A. McGrail. *California's $25 Billion Budget Gap Looms Over Revenue Notes: Muni Credit*, Bloomberg, Nov. 15, 2010, *available at* http://www.bloomberg.com/news/2010-11-15/california-s-25-billion-budget-gap-looms-over-revenue-notes-muni-credit.html.
[104] *Id.*
[105] *Bid Rigging, MF Global, Insider Trading, Cordray: Compliance*, Bloomberg Businessweek, Dec. 9, 2011. available at http://news.businessweek.com/article.asp?documentKey=1376-LVWQ6Z07SXKX01-3PEJRJA8CQEP73F2N5FO71HOQO.
[106] Marois & McGrail, *supra* note 103.

No, the Agencies should not adopt an additional exemption for proprietary trading in options or other derivatives in government obligations.

**Question 122. Should the Agencies adopt an additional exemption for proprietary trading in the obligations of foreign governments and/or international and multinational development banks under section 13(d)(1)(J) of the BHC Act? If so, what types of obligations should be exempt? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?**

No, the Agencies should not adopt an additional exemption for proprietary trading in the obligations of foreign governments and/or international and multinational development banks. This could lead to more disasters like MF Global, which was precipitated by ostensibly "safe" foreign obligations. The Federal Reserve Bank cannot be the backstop for sovereign debt issues; that is, it cannot take on the responsibility of bailing out entire countries or central banking institutions.

**Question 123. Should the Agencies adopt an additional exemption for proprietary trading in any other type of government obligations under section 13(d)(1)(J) of the BHC Act? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?**

No, an additional exemption for proprietary trading in any other type of government obligations would not promote the safety and soundness of banking entities and the financial stability of the United States.

**Question 124. Are the definitions of "government security" and "municipal security" in sections 3(a)(42) and 3(a)(29) of the Exchange Act helpful in determining the proper scope of this exemption? If so, please explain their utility and how incorporating such definitions into the exemption would be consistent with the language and purpose of section 13 of the BHC Act.**

We encourage the use of existing definitions in other areas of securities law to the extent that those definitions are consistent with the language and purpose of Section 13 of the BHC Act.

**Question 125. Is the proposed rule's articulation of three categories of transactions on behalf of customers effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should any of the categories be eliminated? Should any additional categories be added? Please explain.**

The categories appear to be effectively articulated and sufficiently clear, although we propose alternative language to one of the categories, as discussed in Question 126.

**<u>Question 126</u>. Is the proposed rule's exemption of certain investment adviser, commodity-trading advisor, trustee or similar fiduciary transactions effective? What other types of relationships are or should be captured by the proposed rule's reference to "similar fiduciary relationships," and why? Is application of this part of the exemption to particular transactions sufficiently clear? Should any other specific types of fiduciary or other relationships be specified in the rule? If so, what types and why? What impact will the proposed rule's implementation of the exemption have on the investment adviser, commodity-trading advisor, trustee or similar fiduciary activities of banking entities? If such impacts are negative, how could they be mitigated or eliminated in a manner consistent with the purpose and language of the statute?**

The language of § _.6(b)(2)(i)(A) does not appear in the statute, and does not fulfill congressional intent. The statute, in Section 619(d)(1)(D) allows for "[t]he purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) on behalf of customers" as a permitted activity. It does not state that these transactions on behalf of customers are to be performed by an investment adviser or by a commodity-trading advisor. Thus, as we outline in *Annexure B*, § _.6(b)(2)(i)(A) must be modified to **only** allow trading on behalf of customers where the banking entity is acting as "trustee, or in a similar fiduciary capacity for a customer."

**<u>Question 127</u>. Is the proposed rule's exemption of riskless principal transactions effective? If not, what alternative would be more appropriate? Is the description of qualifying riskless principal activity sufficiently clear? If not, how should it be clarified? Should the riskless principal transaction exemption include a requirement that the banking entity must purchase (or sell) the covered financial position as principal at the same price to satisfy the customer buy (or sell) order, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee? Why or why not? Should the riskless principal exemption include a requirement with respect to the timeframe in which the principal transaction must be allocated to a riskless principal or customer account? Why or why not?**

As it is currently written, the permitted riskless principal transaction exemption appears to share more qualities with an option than a back-to-back pass through. In a truly "riskless" transaction, there exist no opportunities for the banking entity to influence the transaction's value. We propose specific language to be added to the Rule such that the time and price of any relevant trade is known and agreed upon by both parties. When timing and price need not coincide on both legs of a riskless principal transaction, optionality emerges, which can only be disadvantageous to the client.

We suggest the following alternative definition of riskless principal transaction:

> The covered banking entity is acting as riskless principal in a transaction in which the covered banking entity, after receiving an order to purchase (or sell) a covered financial position from a customer, purchases (or sells) the covered financial position for its own account, to offset a ~~contemporaneous~~ *simultaneous* sale to (or purchase from) the customer, *where the purchase price and offsetting sale price are identical, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee*;

It is clear that any deviation from this structure implicitly includes an element of proprietary trading, and explicitly incentivizes speculative activity. This particular wording would ensure that, when acting as a riskless principal, a banking entity is in fact passing on all gains to the client and is constrained to benefit in no other way.

**Question 128. Is the proposed rule's exemption of trading for separate accounts by insurance companies effective? If not, what alternative would be more appropriate? Does the proposed exemption sufficiently address the variety of customer-driven separate account structures typically used? If not, how should it address such structures? Does the proposed exemption sufficiently address the variety of regulatory or supervisory regimes to which insurance companies may be subject?**

For further discussion, please see Question 134.

**Question 130. Should the term "customer" be defined for purposes of the exemption for transactions on behalf of customers? If so, how should it be defined? For example, would an appropriate definition 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, or (iii) a relationship initiated by the banking entity to a prospective customer for purposes of the transaction?**

The need to identify and quantify which trades are in fact customer servicing and "customer-initiated"[107] is central to the implementation of this Rule. This can only be sensibly accomplished with a clear and specific definition of customer.

Relationships that are "indirect" should never be considered legitimate customer relationships. The inclusion of "indirect" customer relationships would dilute this Rule and render it ineffective. The inclusion of indirect relationships would define a banking entity's customer base to include all direct customers, customers of their direct customers, and all iterative extensions of such. The explicit differentiation between direct and indirect, as well as the

[107] FSOC Study, *supra* note 54, at 3.

explicit exclusion of Indirect from the definition of customer, is essential.

**Question 131. Is the exemption for trading on behalf of customers in the proposed rule over- or under-inclusive? If it is under-inclusive, please discuss any additional activities that should qualify as trading on behalf of customers under the rule. What are the mechanics of the particular trading activity and how does it qualify as being on behalf of customers? Are there certain requirements or restrictions that should be placed on the activity, if permitted by the rule, to prevent evasion of the prohibition on proprietary trading? How would permitting the activity be consistent with the purpose and language of section 13 of the BHC Act? If the proposed exemption is over-inclusive, please explain what aspect of the proposed exemption does not involve trading on behalf of customers within the language and purpose of the statute.**

The existing definition is excessively broad. It should be subject to the restrictions we have outlined in response to Questions 126 and 127, and should incorporate the explicit definition of customer, as discussed in Question 130. The definition is sufficiently broad as to easily accommodate all appropriate behavior, and should not be expanded in any way.

**Question 132. Should any of the statutory requirements for the exemption be further clarified in the proposed rule? If so, how? Should any additional requirements be added? If so, what requirements and why?**

The Agencies should implement the FSOC's recommendation to require certification from any regulated insurance company relying on the § _.6(c) exemption that the exemption is not being used as a means to evade the Volcker Rule's intent. Along the same lines, the Agencies should require periodic audits of any company relying on this exemption. Credit derivatives have many similarities to more traditional insurance products, and an exemption for insurance might be the driver for new insurance products that approximate proprietary positions while skirting the Volcker Rule's restrictions via the § _.6(c) exemption.

**Question 134. For purposes of the exemption, are the insurance company investment laws, regulations, and written guidance of any particular State or jurisdiction insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States? If so, why?**

While the various States may have relatively uniform insurance regulations by virtue of the coordinating impact of the National Association of Insurance Commissioners, certain states may be unduly lax in their actual enforcement of such regulations. Section _.6(c)(4) mirrors its statutory counterpart in permitting Federal banking agencies to consult with relevant insurance commissioners to waive the insurance exemption where actual enforcement is lax. However, the Proposed Rule does not create any timetable or schedule for these consultations. We recommend that the Agencies require that such consultations occur with every State at least once a year.

**Question 136. Is the proposed rule's implementation of the foreign trading exemption effectively delineated? If not, what alternative would be more effective and/or clearer?**

We believe that the foreign trading exemption outlined in § _.6(d) is both clear and effectively delineated. The criteria required to qualify for this exemption, § _.6(d)(1)(i) and (iii), are appropriate, effective, and must be retained in the Final Rule. Also, the Final Rule must require that **all** of these criteria be met in order for the exemption to apply.

The criteria of § _.6(d)(1)(i) ensure that U.S.-domiciled banks do not simply ship their proprietary trading offshore, as has been done through entities like Edge Corporations in the past.[108] It is also important that holdings of U.S. banking entities that are **already** offshore, as they are for 59% of J.P. Morgan's fair-value derivative assets,[109] are not allowed to skirt the Volcker Rule. This is why is it so important for § _.6(d)(1)(i) to be retained in the Final Rule.

Section _.6(d)(1)(iii) is also critical because its absence may give foreign banks in the United States a near-term competitive advantage. This advantage is near-term because, while proprietary trading can often be profitable, it can also be the source of massive losses that can more than wipe out any profits that may have been made historically. But far more importantly, failing to retain § _.6(d)(1)(iii) in the Final Rule would mean that foreign banks could conduct proprietary trading through their U.S. offices and enjoy the benefits of being in the U.S. markets without being required to adhere to the rule of law in this country.

**Question 138. Are the proposed rule's provisions regarding when an activity will be considered to have occurred solely outside the United States effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should any requirements be modified or removed? If so, which requirements and why? Should additional requirements be added? If so, what requirements and why?**

The NPR's provisions on when the "purchase or sale occurs solely outside of the United States" are sufficiently clear and most effective. There are **no** requirements that should be removed. Any dilution of the current definition will only serve to provide safe harbor for banking entities

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[108] *See* Silla Brush, *Goldman Sachs Among Banks Fighting to Exempt Half of Swaps Books*, Bloomberg, Jan. 30, 2011, *available at* http://www.bloomberg.com/news/2012-01-30/goldman-sachs-among-banks-lobbying-to-exempt-half-of-swaps-from-dodd-frank.html ("Edge corporations, formed under the 1919 Edge Act on international banking, are bank subsidiaries for which Congress granted greater leeway to compete overseas. . . . Banks are seeking to have Edge corporations and other international affiliates exempted from Dodd-Frank rules when they have contracts with non-U.S. companies, Sullivan & Cromwell said in a letter on June 29.").

[109] *Id.* ("The Fed filings show that JPMorgan Chase & Co. had 59 percent of its $188 billion [in fair-value derivatives assets and liabilities] in overseas branches or international affiliates; Citigroup Inc. (C) had 53 percent of $122 billion; and Bank of America Corp. had half of $125 billion in non-U.S. operations in the same period.").

to evade the rules through clever structuring of affiliates, subsidiaries, Edge Corporations or other structures, so as to qualify for the § _.6(d)(1) exemption and thus subvert the Rule.

**Question 139. Is the proposed rule's definition of "resident of the United States" effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Is the definition over- or under-inclusive? If so, why? Should the definition more closely track, or incorporate by reference, the definition of "U.S. person" under the SEC's Regulation S under the Securities Act? If so, why?**

The definition of "resident of the United States" is neither over- nor under-inclusive, and we support the definition as written. It is sufficiently clear and thorough to prevent rule evasion on the part of the banking entities through the use of the exemption in § _.6(d)(1).

**Question 140. Does the proposed rule effectively define a resident of the United States for these purposes? If not, how should the definition be altered?**

We feel the definition of "resident of the United States" in § _.2(t) is well phrased and effective. We also feel it is sufficiently broad so as to prevent regulatory evasion on the part of the banking entities. It is crucial that all elements (1-8) of § _.2(t) be retained in the Final Rule, or there will be cases where the banking entities are able to evade the rules through the permitted foreign trading exemption.

**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? If so, under what circumstances should this be permitted and how would such activity promote and protect the safety and soundness of banking entities and the financial stability of the United States?**

The Agencies should **not** use the authority provided to them under section 13(d)(1)(J) 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 any circumstances. Such an allowance would only serve to weaken the Rule and dilute statutory intent.

**Question 142. Should the Agencies adopt any exemption from the prohibition on proprietary trading under section 13(d)(1)(J) of the BHC Act? If so, what exemption and why? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?**

Metaphorically speaking, it might as well be asked if policemen should issue any exemption from the prohibition on murder to promote and protect the safety and soundness of civil society

in the United States. The addition of any more exemptions beyond the myriad loopholes already contained in the Proposed Rule would be farcical in appearance and likely disastrous in effect.

**Question 143. Is the use of the proposed reporting requirements as part of the multifaceted approach to implementing the prohibition on proprietary trading appropriate? Why or why not?**

We feel that the proposed reporting requirements are important to enforcement of the Rule. While we have strongly argued in earlier questions against any exclusion of repurchase and reverse repurchase agreements from the definition of trading account, should our request be denied, we feel it is imperative that **all** trading, be it excluded trading or not, should require quantitative measurements and risk reporting.

**Question 144. Is the proposed gradual approach to implementing reporting requirements effective? If not, what approach would be more effective? For example, should the Agencies defer reporting of quantitative measurements until banking entities have developed and refined their compliance programs through the supervision and examination process? What would be the costs and benefits of such an approach?**

We do **not** believe it would be effective to defer the reporting of metrics until the banking entities have developed their compliance programs. Banks already keep all or nearly all of the suggested metrics, and thus it should be straightforward to begin reporting on Day One. As we mentioned in Question 147, developing aggregate risk reports was one of the most universal reactions to the 2008 crisis.

That said, we understand that it may take a substantial amount of time to arrive at unified, accurate reporting on all metrics, but we do not feel that metrics should be stalled while waiting for perfect reporting.

**Question 145. What role, if any, could or should the Office of Financial Research ("OFR") play in receiving and analyzing banking entities' reported quantitative measurements? Should reporting to the OFR be required instead of reporting to the relevant Agency, and would such reporting be consistent with the composition and purpose of OFR? In the alternative, should reporting to either (i) only the relevant Agency (or Agencies) or (ii) both the relevant Agency (or Agencies) and OFR be required? If so, why? What are the potential costs and benefits of reporting quantitative measurements to the OFR? Please explain.**

We believe that the purview of the Office of Financial Research ("OFR") fits well with the need for conducting analysis on the quantitative measurements required by Volcker. We also feel that OFR is an excellent candidate to serve as a central data repository for these metrics. Because OFR is meant to be a point of access for all the Agencies, it would help intra-Agency

coordination of enforcement and record keeping if OFR were the central store for all metrics data. That said, we do not feel strongly that OFR must be the central store of metrics data. Rather, we simply feel that a centralized store must exist. Whether the repository is with OFR or one of the other Agencies is less relevant than ensuring that all Agencies can store and retrieve Volcker-related metrics at a single central location. We feel such a service would go very far toward ensuring optimal enforcement and monitoring.

We also want to ensure that staffing levels, budgets and other resources are sufficient to allow for effective execution. We are aware that this and other sections of the rule give numerous new mandates to the Agencies, and it is not clear to us that the current number of employees or fellows at the OFR is sufficient to manage the entire task of analyzing metrics. Additionally, if the OFR is the only group analyzing metrics, we are concerned that this will place an additional burden on OFR staff of coordinating with all enforcing Agencies. Thus, given the information available to us, our suggestion is that the burden of analyzing these metrics should be spread among the Agencies—with all analysis shared—to enable the best metrics-gathering possible given current resourcing.

We are optimistic about the OFR's ability to be funded through fees garnered from assessments on banking entities.[110] Since the Agencies receive variable funding through Congress, it seems that the most reliable approach would be for metrics analysis to be done through OFR, assuming it is able to assess regular fees on the banking entities, sufficient to fund the much-needed work of metrics analysis.

**<u>Question 146</u>. Is there an alternative manner in which the Agencies should develop and propose the reporting requirements for quantitative measurements? If so, how should they do so?**

Although we feel that the approach outlined is constructive, we feel additional steps should be taken to understand each banking entity's reported metrics. We suggest that the Agencies publish a benchmark portfolio of securities and require that each banking entity evaluates this portfolio according to their own risk measurements.

In order to understand how the risk measurements requested are calculated at various Banking Entities, the Agencies should choose a basket of securities (a benchmark portfolio whose contents are public information) that all Banking Entities must evaluate. This idea, first outlined

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[110] Jennifer Taub, *Great Expectations for the Office of Financial Research, in Will it Work? How Will We Know? The Future of Financial Reform* 24 (Roosevelt Institute 2010). *available at* http://www.rooseveltinstitute.org/sites/all/files/Will It Work Financial Research.pdf ("After two years of initial funding by the Fed, the OFR will secure permanent funding through assessments on large banks and other systemically important financial firms. However, under Dodd-Frank, it does not have control over the schedule. It is the Secretary of Treasury, in consultation with the Council, who will establish the assessments.").

in a letter to the Financial Times by Vikram Pandit,[111] will reveal differences in each entity's models and highlight to regulators any areas where models are being used to understate real risk.

Ideally, this approach would include not a single benchmark portfolio, but rather a series of benchmark portfolios for different instrument classes. Such an approach would deter evasion through manipulation of metrics.

**Question 147. Does the proposed approach provide sufficient time for the development and implementation of effective reporting requirements? If not, what alternative approach would be preferable?**

We feel strongly that the time allotted for compliance with the Volcker Rule and all related metrics reporting is more than adequate. Any suggestions to the contrary are likely to be politically motivated stalling tactics. It is our experience at many of the largest financial firms in this country and abroad that after the financial crisis of 2008, every firm that did not already have bank-wide aggregate risk metrics quickly began to draft implementation plans on how to make such monitoring and reporting a reality. In addition, given the industry-wide focus on risk in the wake of the crisis, many firms are busy creating low latency pre-trade risk systems, allowing for pre-trade checks on risk for themselves and direct market access systems.[112] Banks that claim to the Agencies that there is not sufficient time to develop and implement the reporting requirements are actively denying the simple fact that similar initiatives were launched, planned, and executed in the wake of the 2008 crisis.

**Question 148. Should a trading unit be permitted not to furnish a quantitative measurement otherwise required under Appendix A if it can demonstrate that the measurement is not, as applied to that unit, calculable or useful in achieving the purposes of the Appendix with respect to the trading unit's covered trading activities? How might a banking entity make such a demonstration?**

We are wary of allowing trading units to lobby for particular metrics to be removed from their reporting requirements. We feel that any decision made on skipping a particular metric should

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[111] Vikram Pandit, *Apples v Apples – a New Way to Measure Risk*, Financial Times, Jan. 10, 2012, *available at* http://www.ft.com/intl/cms/s/0/90bb724a-3afc-11e1-b7ba-00144feabdc0.html.

[112] Melanie Rodler, *Capital Markets Outlook 2012: Risk Tools*, Wall Street & Technology, http://www.wallstreetandtech.com/2012-outlook/risk-tools (last visited Feb. 5, 2012) ("Wall Street firms have been busily revamping their electronic trading platforms to ensure that they can perform pre-trade risk checks faster than ever before. . . .Bank of America Merrill Lynch recently announced BofAML Express, an ultralow-latency market access and risk control platform for U.S. equities that provides embedded risk controls with sub-10 microseconds of wire-to-wire latency. Morgan Stanley is using software to shave latency from its compliant direct-market-access platform, Speedway 3.0, which is live with at least five exchanges, including NYSE, ARCA, Nasdaq, BATS and the two Direct Edge exchange platforms. And Deutsche Bank is employing field-programmable gate array (FPGA)-based devices to lower latency for its risk checks.").

be standardized across banks by individual asset classes or products by OFR or one of the Agencies.

We believe OFR is well suited to set the standard. If allowances are made, they should not be at the request of a trading unit at a particular bank, but rather because the Agencies decide that a specific metric is not relevant or useful for a given asset class or product type. Failure to make such decisions for all banking entities could lead to obfuscation of metrics.

**Question 149. Is the manner in which the Agencies propose to utilize the conformance period for review of collected data and refinement of the reporting requirements effective? If not, what process would be more effective?**

Although we are generally in favor of faster and more aggressive implementation, it seems plausible that in this case further accelerating implementation might lead to an unmanageably large quantity of data being presented to the Agencies. If this quantity is large enough it may interfere with a meaningful response. So, while we urge faster implementation, we also urge the Agencies to exercise their discretion and ensure that no obfuscating "data deluge" occurs.

**Question 150. Is the proposed $1 billion trading asset and liability threshold, which is also currently used in the Market Risk Capital Rules for purposes of identifying which banks and bank holdings companies must comply with those rules, an appropriate standard for triggering the reporting and record-keeping requirements of the proposed rule? Why or why not?**

We believe that there are several amendments and clarifications that must be made to the calculation of the $1 billion threshold before it can be considered a useful trigger for reporting purposes. Specifically, we feel that the Agencies should ensure that *all assets and liabilities defined as trading assets for purposes of the Market Risk Capital Rule are included in the $1 billion standard* for triggering the Volcker Rule's reporting and record-keeping requirements.

Specifically, we feel that the NPR is not sufficiently clear about the definition of "trading assets and liabilities" for the purposes of calculating the $1 billion threshold. While there are numerous precedents for this definition, such as language in Form Y9-C's Schedule HC-D,[113] as well as in the Call Report's Schedule RC-D,[114] the Rule does not explicitly give a definition of "trading assets and liabilities" or point to any existing standard definition. We feel further clarity is required in the Final Rule, especially given our understanding that the NPR considers the $1

[113] Bd. of Governors of Fed. Reserve Sys., Form Y-9C, Schedule HC-D: Line Item Instructions for Trading Assets and Liabilities, *available at* http://www.federalreserve.gov/reportforms/forms/FR_Y-9C20111231_i.pdf.
[114] Fed. Deposit Ins. Corp., Schedule RC-D – Trading Assets And Liabilities, Reports of Condition and Income Instruction Book, *available at* http://www.fdic.gov/regulations/resources/call/crinst/2011-09/911RC-D_093011.pdf.

billion total to be calculated only for "covered trading activities."[115] We do not feel this is adequate.

The Agencies note that this $1 billion trading asset and liability threshold is the same quantitative standard used in the Market Risk Capital Rules for determining which bank holding companies and insured depository institutions must calculate their risk-based capital requirements for trading positions. But it does not clarify whether or not "trading assets and liabilities" will match the standard of the Market Risk Capital Rules, which define "trading assets and liability" by referring to the standard defined in the Call Report.[116] It is unclear from the NPR if that is the same standard that will be used for the threshold calculation. The comparison between the NPR's threshold and the Market Risk Capital's $1 billion threshold is not meaningful **unless** the assets counted in these two rules are equivalent.

Any failure to include the assets of currently excluded agreements such as repos, securities lending, and liquidity management plans in the $1 billion threshold calculation could lead to evasion of reporting. Banking entities may seek to financially engineer trades as structured repos, or simply claim they are "liquidity management" positions in order to fall underneath the $1 billion threshold, thereby avoiding reporting and record-keeping requirements.

Thus, we feel that the $1 billion threshold must be applied against all of the following positions, even though these positions are currently excluded from the definition of trading account[117] by the NPR:

- Positions arising under certain repurchase and reverse repurchase arrangements or securities lending transactions,
- Positions acquired or taken for bona fide liquidity management purposes, and
- Certain positions of derivatives clearing organizations or clearing agencies.

Since these positions will likely be large and have a significant impact on the capital calculation, it is prudent to include these assets and liabilities in the reporting requirement trigger.

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[115] *NPR at* 68.918 ("[A] banking entity must comply with the minimum standards specified in Appendix C of the proposed rule if: • **With respect to its covered trading activities**, it engages in any covered trading activities and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, (i) is **equal to or greater than $1 billion** or (ii) equals 10 percent or more of its total assets") (emphasis added).

[116] 12 C.F.R. part 225, app. B to pt. 3 at § 1(b) n.2 ("Trading activity means the gross sum of trading assets and liabilities as reported in the bank's most recent quarterly Consolidated Report of Condition and Income (Call Report)").

[117] Please see our response to Questions 30-45 for why the dangerous exclusions of repos, securities lending and liquidity management plans from the definition of trading account should be removed in the Final Rule.

To ensure consistency and to eliminate reconciliation issues between the Volcker rule definition of trading account and the Market Risk Capital Rules definition of trading account, the Market Risk Capital Rule definition should prevail for triggering the reporting requirement.

The Calculation Period must be Redefined

The calculation period used to determine the trading asset and liability-reporting trigger is inadequate. These positions will be monitored and calculated on a daily basis at the banks. It is imprudent to measure compliance based on just four days over the previous year.

The $1 billion position limit must be modified to reflect a more accurate measure of the positions taken on the remaining 361 days. Failure to do so could lead to accounting legerdemain to allow a larger banking entity to fall underneath the $1 billion threshold.

Market Risk Capital Rules may Understate the Size of the Trading Account Exposure

Consensus on the measurement of trading account size does not currently exist among the global regulators. The Market Risk Capital Rules referred to in the trading account definition in § _.3 refer to the current *proposed* Market Risk Capital rules. There is considerable debate among regulators and practitioners about appropriate measurement methodologies for structured products like credit default swaps. Therefore, should the Agencies decide not to require reporting across all banking entities, the final reporting trigger should be set low enough to compensate for these measurement shortcomings.

**If not, what alternative standard would be a better benchmark for triggering the reporting and recordkeeping requirements?**

We suggest an alternative that includes the following elements:

- An additional, lower reporting trigger threshold should be established to require reporting if the portfolio of trading assets contains any trading asset that relies on a valuation model, rather than an independent price verification to assign a balance sheet value.
- The values of assets included in the reporting trigger calculation must be refined to reflect actual trading account exposures, rather than trading account balance sheet valuations.
- Adjustments to the Market Risk Capital Rule trading account accounting measurements must be made to appropriately quantify the exposure of so-called Tier 3 Assets (mark-to-model valuations).
- Exposures to forwards and futures must be appropriately included in the threshold. A large futures position will be reported at the current value of the open futures position. The size of the open position does not appear on the balance sheet. As a result, it is conceivable that an open futures position

exceeding $1 billion would not be included in the current threshold calculation.

Should all of the above alternatives be included in the Final Rule, we would support a $1 billion total requirement to trigger reporting and record keeping. We would support this because, if all trading assets (excluded from the definition of trading account or otherwise) are included in that total, $1 billion in assets globally is a sufficiently small sum that such a banking entity should not pose enough of a threat to the financial stability of the United States as to require detailed monitoring of metrics.

**Question 152. Should the proposed $1 billion trading and asset liability threshold used for triggering the reporting and recordkeeping requirements adjust each time the thresholds for complying with the Market Risk Capital Rules adjust, or otherwise be adjusted over time? If not, how and when should the numerical threshold be adjusted?**

We do not believe the $1 billion threshold should be adjusted each time the Market Risk Capital Rules adjust. The negotiation of the Market Risk Capital rules is a separate process, and while those rules may be useful in defining standards for purposes of this rulemaking, they are distinct from the statutory requirements underlying these rules. The statute makes no reference to the Market Risk Capital Rules process. An automatic update to the Volcker Rule based on changes in the Capital rules is unwarranted and imprudent.

The rules should only need to be changed in order to account for the public comment process. An automatic update of the threshold would only serve to undermine that process.

**Question 153. Should all banking entities be required to comply with the reporting and recordkeeping requirements set forth in Appendix A in order to better protect against prohibited proprietary trading, rather than only those banking entities that meet the proposed $1 billion trading asset and liability threshold? Why or why not?**

As discussed in Question 150, we believe that the $1 billion threshold would be sufficient should all of our additions and amendments be incorporated. If the Agencies do not incorporate our suggested revisions to the threshold calculation, we would suggest that all banking entities be required to comply with the reporting and record keeping requirements.

**Question 154. Should banking entities that fall under the proposed $1 billion trading asset and liability threshold be required to comply with the reporting and record-keeping provisions for a pilot period in order to help inform judgment regarding the levels of quantitative measurements at such entities and the appropriate frequency and scope of examination by the relevant Agency for such banking entities? Why or why not?**

We support the suggestion that all banking entities participate in reporting and record keeping during a pilot period. As discussed in Question 147, most of the quantitative data requested is already available at all banks. Much of that data is currently used by banks to prepare their capital requirement reporting as well as manage their exposures.

**Question 155. Are the ways in which the proposed rule would make use of reported quantitative measurements effective? If not, what uses would be more effective?**

We see the uses of reported quantitative measurements as generally comprising three main goals, each of which will reflect varying degrees of effectiveness:

Indication of Prohibited Proprietary Activity
The quantitative measurements mandated by the Proposed Rule will be least effective in serving to identify or predict potential proprietary trading activity within a banking entity. In general, the required measurements may be able to indicate the most serious abuses of this Rule's intent, but the vast majority of proprietary trading would not become differentiable through any analysis of these data.

Indication of High Risk Exposures of Strategies
This will be a much more useful and indicative purpose of the reported quantitative measurements. While the measurements are only as reliable as their component data, and do little to account for extreme events or "fat tails," they will generally provide a high-level overview of an entity's risk profile such that aberrations may be observed or inferred.

General Assessment of Risk Profiles
These quantitative measurements will be **absolutely critical** for the Agencies' ability to monitor and regulate banking entities and their complicated interactions with each other. The quantitative measurements are extremely effective in this capacity.

**Should the proposed rule instead use quantitative measurements as a dispositive tool for identifying prohibited proprietary trading? If so, what types of quantitative measurements should be employed, what numerical amount would indicate impermissible proprietary trading activity, and why?**

There are serious limits to the capabilities of these measurements, and the potential for abuse and manipulation of input data is significant. We urge the Agencies to always take a holistic view of risky activities, and never rely on these measurements as dispositive tools for anything.

**Should the quantitative measurements play a less prominent role than proposed in identifying prohibited proprietary trading and why?**

Despite their various shortcomings, we are strongly in support of the current requirements for quantitative measurements, and do **not** feel that their role should be in any way diminished. Without the reporting of these measurements, we believe there would be significant evasion of the Volcker Rule by the banking entities.

**Question 157. Is the proposed definition of "trading unit" effective? Is it sufficiently clear? If not, what alternative definition would be more effective and/or clearer? Should the definition include more or less granular levels of activity? If so, what specific criteria should be used to determine the appropriate level of granularity?**

Our major concern lies with the possibility of the Volcker Rule allowing for an inappropriately large trading unit.

The "trading desk" is the most fundamental, universally understood unit in every trading or market making operation. Risk exposure and related compensation are inextricably linked to the trading desk. While risk management also happens at higher levels with several trading desks combining to form a larger category of trading (e.g., Global Credit Derivatives, U.S. Equity Derivatives, etc.), we are concerned that the current definition may allow for inordinately large units. An oversized "trading unit" could combine significantly unrelated trading desks, which would impede detection of proprietary trading activity.

A more effective alternative definition would be to use the criteria listed in footnote 191 of the Supplementary Information. Footnote 191 defines the trading unit with sufficient granularity. The Rule needs to explicitly incorporate those criteria in the final definition.

**Question 159. Is the proposed rule's requirement that quantitative measurements be reported at multiple levels of organization, including for quantitative measurements historically reported on an aggregate basis (e.g., Value-at-Risk ("VaR") or Stress VaR) appropriate?**

We believe that it is appropriate and correct that the NPR requires measurements at multiple levels of organization.

We suspect that the banking entities will argue that quantitative measurements such as VaR have limited utility at a disaggregated level, and that requiring the analysis at that level will impose an unnecessary and costly burden on them. We further suspect that they may argue that VaR as a metric is flawed. While both arguments have merit in some other contexts, we believe they are irrelevant for purposes of this rule making.

Desk-level VaR is extremely useful to the regulators as an indicator of the existing risk sensitivity on trading and market making desks. As a regulatory tool, VaR is useful as a measure of exposure to market risks.

Since there should be zero exposure to non-permitted trading activity, any significant VaR on a trading desk should be interpreted by the regulators as a clear, early warning signal that something is amiss.

In an imperfect world, VaR still serves the useful purpose of immediately alerting regulators to compare the underlying sensitivities (which will be reported to the regulators concurrent with the VaR statistics) against the Rule's limitations.

**If not, what alternative would be more effective? What burdens are associated with such a requirement? How might those burdens be reduced or limited? Please quantify your answers, to the extent feasible.**

The burden associated with the requirement to provide the Appendix A quantitative measures will be borne by those banks that benefit from the Volcker Rule's permitted activities. For legitimate market makers with near-zero market risk, or banks that do not participate in proprietary trading activity, calculating VaR at a desk level will impose only a marginal additional cost. The additional compliance costs are outweighed by the benefits compliant banks receive in the form of explicit and implicit government guarantees.

**Question 160. Is the proposed tiered approach to identifying which banking entities and trading units must comply with the reporting requirements effective? If not, what alternative would be more effective?**

Our concerns with the current approach are mainly focused on the $1 billion threshold calculation, as well as the difficulty of valuing derivatives assets for the purpose of the reporting trigger. For further discussion, please see our answers to Questions 150 and 162.

**Does the proposal strike the appropriate balance between the potential benefits of the reporting requirements for monitoring and assuring compliance and the potential costs of those reporting requirements?**

The appropriate balance has been reached between benefits and costs. In fact, based on the set of quantitative measures required to be reported, there should only be a marginal cost to the banks to provide this information to the regulators, as most quantitative measures are already produced at the banks.

**If not, how could that balance be improved? Should the relevant gross trading assets and liabilities threshold for any category be increased or reduced? If so, why?**

We do not believe that any thresholds should be increased. For a further discussion of our concerns with the existing trading assets and liabilities threshold, please see our answer to Question 150.

**Question 161. Should the $1 billion and $5 billion gross trading assets and liabilities thresholds used to identify the extent to which a banking entity is required to furnish quantitative measurements be increased or reduced? If so, why?**

For further discussion, please see Question150.

**Should the thresholds be indexed in some way to account for fluctuations in capital markets activity over time? If so, what would be an appropriate method of indexation?**

We do not feel that it is necessary to index the thresholds to account for fluctuations in capital markets activity.

**Question 162. Is the proposed $5 billion trading asset and liability threshold an appropriate standard for triggering enhanced reporting requirements under the proposed rule? Why or why not? If not, what alternative standard would be a better benchmark for triggering enhanced reporting requirements?**

All banks that meet the $1 billion trading asset and liability threshold should by required to conduct enhanced reporting. This is important because, even in the criteria set by the Call Report's Schedule RC-D, credit default swaps and other derivatives may be valued substantially lower than their inherent risk.[118] For example, a $100 million credit default swap could have a "fair value" of only $75,000. Thus, neither the $1 billion nor the $5 billion threshold is meaningful should the banking entity hold a substantial portion of its assets in derivatives the "fair value" calculation of which may not properly reflect the inherent risk involved.

**Question 163. Should the proposed $5 billion trading and asset liability threshold used for triggering enhanced reporting requirements under the proposed rule be subject to adjustment over time? If so, how and when should the numerical threshold be adjusted?**

The $5 billion trading and asset liability threshold for enhanced reporting should not be subject to adjustment over time.

**Question 164. Is there a different criterion other than gross trading assets and liabilities that would be more appropriate for identifying banking entities that must furnish**

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[118] Fed. Deposit Ins. Corp., *supra* note 114, at 5. Item 11. ("Derivatives with a positive fair value."). *See also id.* at Item 14 ("Derivatives with a negative fair value.").

**quantitative measurements? If so, what is the alternative criterion, and why would it be more appropriate?**

If the Agencies account for the concerns we raise in Question 162 about the difficulties of valuing derivatives, and our request for a strict definition of "trading assets and liabilities" as discussed in Question 150, the current trigger for enhanced reporting will be adequate.

**Are worldwide gross trading assets and liabilities the appropriate criterion for foreign-based banking entities? If not, what alternative criterion would be more appropriate, and why?**

Worldwide gross trading assets and liabilities are absolutely the correct criterion for foreign-based banking entities. Foreign affiliates must face the same constraints on their U.S. affiliates as their U.S. competitors do if they want to conduct business in the U.S. and with U.S. customers.

**Question 165. Are the quantitative measurements specified for the various types of banking entities and trading units effective? If not, what alternative set of measurements would be more effective? For each type of trading unit, does the proposal strike the appropriate balance between the potential benefits of the reporting requirements for monitoring and assuring compliance and the potential costs of those reporting requirements? If not, how could that balance be improved?**

The specified measurements are effective because they are the most indicative standard market metrics available today. They do contain numerous and extensive shortcomings, which must be tolerated in the absence of superior risk methodologies.

With respect to the balance of benefits vs. cost, we would hope that if more appropriate or indicative measurement methodologies were to become available, the cost of such would not be a relevant factor. The regulatory value of each piece of data already significantly outweighs the operational cost of calculating and reporting it, and such reporting could conceivably be much more expensive before its incremental value could be reasonably called into question. We urge the Agencies not to attempt to upset this balance, in favor of cost, in any way.

**Question 166. Should banking entities with gross trading assets and liabilities between $1 billion and $5 billion also be required to calculate and report some of the quantitative measurements proposed for banking entities meeting the $5 billion threshold for purposes of assessing whether the banking entity's underwriting, market making, risk-mitigating hedging, and trading in certain government obligations activities involve a material exposure to high-risk assets or high-risk trading strategies?**

Yes.

**If so, which quantitative measurements and why? If not, why not?**

These banking entities should be additionally required to furnish:

VaR Exceedance
These firms will already be calculating and reporting VaR, so this should be a simple and illustrative addition.

Risk Factor Sensitivities
All banking entities that maintain risky portfolios will already be calculating their risk factor sensitivities, and should be able to easily furnish these to the Agencies. This will help the Agencies gather holistic data about the market, its participants, and their relative exposures within it. It should be highlighted that even very small firms can have large notional derivative exposure, due to the current "fair value" accounting treatment that such derivatives receive for purposes of qualifying as trading assets and liabilities.

Risk and Position Limits
Limits-setting/limits-monitoring is a basic requirement for a banking entity's compliance procedures. It should be reported to the regulators to evidence the effective operation of the policies and procedures implemented as part of a bank's compliance program.

**Question 167. Is the proposed frequency of reporting effective? If not, what frequency would be more effective? Should the quantitative measurements be required to be reported quarterly, annually, or upon the request of the applicable Agency and why?**

The reporting frequency is effective and should not be reduced in any way.

**Question 168. Are the proposed quantitative measurements appropriate in general? If not, what alternative(s) would be more appropriate, and why? Should certain quantitative measurements be eliminated, and if so, why? Should additional quantitative measurements be added? If so, which measurements and why? How would those additional measurements be described and calculated?**

The proposed quantitative measurements are generally appropriate for certain liquid and transparent trading activities. We have some specific concerns with methodology, which will be addressed in the following questions. Many of the measurements are not meaningful in illiquid markets (Spread P&L, for example) or for derivatives instruments (for instance, Inventory Turnover), and these products should be considered prohibited, as they are unable to provide even the most basic reliable data.

An important measurement that is missing from this list is a Liquidity "Gap Risk" metric, which estimates the price change that occurs following a sudden disruption in liquidity for a product. There needs to be an industry-wide effort to more accurately measure and account for the significant effect that liquidity, and changes in its prevailing level, have on the valuation of each asset.

We also recommend that VaR back-testing results be added to the list of required metrics. This would provide a more robust measure than the proposed VaR Exceedance requirement. These results compare actual profit and loss to VaR estimates and can be used by the regulators to evaluate the effectiveness of the VaR model for capital calculation purposes. These results should be incorporated into the quantitative measures requirement to help the regulators determine the reliability of the VaR data.

Additionally, entity-wide inflation risk and counterparty risk assessments should be produced on a daily basis.

**Question 169. How many of the proposed quantitative measurements do banking entities currently utilize? What are the current benefits and costs associated with calculating such quantitative measurements? Would the reporting and recordkeeping requirements proposed in Appendix A for such quantitative measurements impose any significant, additional benefits or costs?**

Banking entities currently utilize, or calculate the necessary data to utilize all of the listed quantitative measurements. The reporting and recordkeeping requirements will cause no real additional costs, but the increased priority and attention to quality demanded by this Rule will clearly produce significant benefits for the banking entities.

**Question 170. Which of the proposed quantitative measurements do banking entities currently not utilize? What are the potential benefits and costs to calculating these quantitative measurements and complying with the proposed reporting and recordkeeping requirements? Please quantify your answers, to the extent feasible.**

For further discussion, please see Question 169.

**Question 171. Is the scope and frequency of required reporting appropriate? If not, what alternatives would be more appropriate? What burdens would be associated with reporting quantitative measurements on that basis, and how could those burdens be reduced or eliminated in a manner consistent with the purpose and language of the statute? Please quantify your answers, to the extent feasible.**

A general inconsistency is found in the NPR's recordkeeping requirement, which states:

> Covered banking entities must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program. A covered banking entity must retain these records for a period that is no less than 5 years in a form that allows it to promptly produce such records to [Agency] on request.[119]

We propose this requirement be amended to 6 years, such that it matches the New York State Statute of Limitations for civil actions relating to contracts and fraud.[120]

**Question 172. For each of the categories of quantitative measurements (e.g., quantitative measurements relating to risk management), what factors should be considered in order to further refine the proposed category of quantitative measurements to better distinguish prohibited proprietary trading from permitted trading activity? For example, should the timing of a calculation be considered significant in certain contexts (e.g., should specific quantitative measurements be calculated during the middle of a trading day instead of the end of the day)? Please quantify your answers, to the extent feasible.**

For further discussion, please see Question 174.

**Question 173. In light of the size, scope, complexity, and risk of covered trading activities, do commenters anticipate the need to hire new staff with particular expertise in order to calculate the required quantitative measurements (e.g., collect data and make computations)? Do commenters anticipate the need to develop additional infrastructure to obtain and retain data necessary to compute the proposed quantitative measurements? Please explain and quantify your answers, to the extent feasible.**

The relevant infrastructure is already in place, and minimal additional resources should be required to implement the reporting of quantitative measures in this Rule. For further discussion, please see Question 174.

**Question 174. For each individual quantitative measurement that is proposed:**

**Is the use of the quantitative measurement to help distinguish between permitted and prohibited trading activities effective? If not, what alternative would be more effective? Does the quantitative measurement provide any additional information of value relative to other quantitative measurements proposed?**

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[119] NPR at 68.936.
[120] *See* N.Y. Civ. Prac. L. & R. § 213 (2012).

Generally, we agree that the quantitative measures defined in Appendix A are useful for distinguishing between permitted and prohibited activities. However, we have concerns about the specific measures that should be addressed in the Final Rules.

VaR, Stress VaR, and VaR Exceedance

We have a number of criticisms of current Value-at-Risk measurements and methodologies, but in general we recognize that this metric is ubiquitous because a superior alternative has not been developed.

In general, we would like to emphasize that VaR calculations are heavily reliant on the quality of input data, and many markets are unable to provide sufficient information such that VaR calculations are meaningful. In particular, illiquid products for which accurate historical price and market information is sparse can severely under-represent true potential losses under VaR calculations. We caution the Agencies to treat all quantitative data with due caution and approach their value with appropriate expectations.

VaR gives a *very* high level indication of the level of risk held by a banking entity at a given time. In theory, generally high levels of risk, or abnormalities in risk profiles, may be indicative of inappropriate warehousing of risk, and therefore of proprietary activity. In general, however, we expect this measure to indicate a general snapshot of risk levels for the purpose of comparison within the industry.

VaR Exceedance may be useful to the regulators as an indicator of the quality of the VaR measure relative to the profit and loss associated with a trading unit. A more rigorous back-testing process would serve as a better analytical tool to evaluate the quality of the VaR model result and should be included as an additional metric.

Risk Factor Sensitivities Risk and Position Limits

Risk Factor Sensitivities will be the most useful tool for identifying the accumulation of risk in different areas of a banking entity.

It is unclear to us how Position Limits are in fact a quantitative measurement, and not a description of a banking entity's internal risk policies. This may be an important piece of information for the Agencies, but it is not an overly important piece of data with respect to identifying proprietary trading activities.

Comprehensive Profit and Loss, and Portfolio Profit and Loss

If these metrics are responsibly calculated and reported, they should serve as a secondary indication of risk levels taken throughout an entity. We would like to caution the Agencies that these will be the most commonly understood metrics and therefore hold the greatest risk of manipulation by individuals within the banking entity.

Fee Income and Expense
This will be a tremendously useful indication in liquid markets that trade with the convention of fees and commissions. This metric will be less useful, but still indicative, in other markets that use inter-dealer brokers to conduct non-client activities.

Spread Profit and Loss
Spread Profit and Loss is **not** effective as defined. This may be a useful metric in very liquid markets, but we see the NPR's potential reliance on this particular quantitative measurement within illiquid markets as an indication of a very serious lack of understanding of how such markets behave.

The current definition provides the banks with almost total discretion over these numbers. As a consequence, any firm that has a trading unit with illiquid products for which a bid/ask spread is unobtainable will report aggregated metrics such as VaR and Comprehensive Profit and Loss attribution based on unconfirmable data.

There is currently no requirement to disclose the impact of the contribution of these trading units' positions in the aggregated metrics. That impact must be clearly disclosed for all affected metrics. It should further be documented that including such "guesswork" serves to compromise the integrity of the remaining data.

In our experience, it is very well-known that reliance on such "proxy" instruments for illiquid pricing predominantly yields arbitrary or even outright false information, in all cases serving to provide the greatest mark-to-market benefit to the relevant trader. In any of a variety of products that have zero applicable market data, and this "garbage in" is in fact what such proxy regimes are demanding.

If banking entities are permitted to continue trading illiquid products and some attempt to artificially quantify them must be made, we urge the Agencies to understand that the resulting reports will yield very little useful data and should be treated with extreme caution.

Comprehensive Profit and Loss Attribution
This is a good, common sense metric that will serve to provide a general overview of a banking entity's trading and risk activities.

Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss
These are good, common sense metrics that may serve to highlight areas requiring further investigation, since high P&L volatility may indicate a deviation from traditional client-related activities.

Unprofitable Trading Days based on Comprehensive P&L, and on Portfolio P&L

These are good, common sense metrics that may serve to highlight areas requiring further investigation, since a significant number of unprofitable trading days may indicate a deviation from traditional client-related activities.

Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss
This is a useless measure as currently defined, as explained below.

Inventory Aging, and Inventory Turnover
This is a useful metric only with respect to certain cash securities. With derivative securities, Inventory is not a useful factor for the purposes of this Proposed Rule.

Customer-facing Trade Ratio
This will be an incredibly illuminating metric if the word "customer" is defined in this Rule as we have repeatedly proposed in this comment letter. The failure to differentiate between customers and other non-customer counterparties, however, will render this metric a meaningless one.

Pay-to-Receive Spread Ratio
This will not be a useful metric because it is neither possible to collect useful data on bid/offer spreads for many products, nor are there systems in place to capture or monitor such data.

Because adequate data often simply does not exist for illiquid and many OTC products, and it follows that proper risk management and oversight is impossible for such instruments, they should not be permitted as trading activities in covered banking entities.

**Is the use of the quantitative measurement to help determine whether an otherwise-permitted trading activity is consistent with the requirement that such activity must not result, directly or indirectly, in a material exposure by the banking entity to high-risk assets and high-risk trading strategies effective? If not, what alternative would be more effective?**

The following metrics will be useful in possibly alerting the Agencies to excessive risk warehousing across products, which could potentially be useful for the purpose of identifying high-risk assets and trading strategies:

- VaR, Stress VaR, and VaR Exceedance
- Risk Factor Sensitivities
- Comprehensive Profit and Loss, and Portfolio Profit and Loss
- Comprehensive Profit and Loss Attribution
- Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss
- Comprehensive P&L to Volatility Ratio, and Portfolio P&L to Volatility Ratio

- Unprofitable Trading Days based on Comprehensive P&L, and on Portfolio P&L
- Inventory Aging, and Inventory Turnover

**What factors should be considered in order to further refine the proposed quantitative measurement to better distinguish prohibited proprietary trading from permitted trading activity? For example, should the timing of a calculation be considered significant in certain contexts (e.g., should specific quantitative measurements be calculated during the middle of a trading day instead of at the end of the day)?**

Risk Factor Sensitivities, Portfolio Profit and Loss
Because it may be possible to disguise risk factor sensitivities at particular calculation times, we suggest several risk factor sensitivity snapshots be taken throughout the day, with an average value reported at the end of the day to the Agencies.

The Portfolio P&L associated with such sensitivities should always be reported in conjunction with them.

**If the quantitative measurement is proposed to be applied to a trading unit that is engaged in activity pursuant to §§ _.4(a), __.5, or __.6(a) of the proposed rule, is the quantitative measurement calculable in relation to such activity?**

Spread Profit and Loss
Spread Profit and Loss will not be meaningfully calculable in relation to any activity in illiquid assets.

**Is the quantitative measurement useful for determining whether underwriting, risk mitigating hedging, or trading in certain government obligations is resulting, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies?**

The relevant quantitative measurements are calculable in relation to such activity, and are able to provide general guidance regarding high risk-assets or trading strategies. There are serious limits to the capabilities of these measurements, however, and they should never be considered to be dispositive indicators of high-risk assets or high-risk trading strategies.

**Is the description of the quantitative measurement sufficiently clear? What alternative would be more appropriate or clearer? Is the description of the quantitative measurement appropriate, or is it overly broad or narrow? If it is overly broad, what additional clarification is needed? Should the Agencies provide this additional clarification in the appendix's description of the quantitative measurement? If the description is overly**

**narrow, how should it be modified to appropriately describe the quantitative measurement, and why?**

With the exceptions noted below, we believe the description of the quantitative measures is sufficiently clear.

VaR, Stress VaR, and VaR Exceedance
The definition of VaR has not been made clear as it is missing some important information regarding methodology. The exact calculation method should be specified by the Agencies, and standard guidance should be provided as follows:

Variability of the VaR model result against a standard benchmark portfolio should be reported to the regulators. We recommend that the OFR define a benchmark portfolio and calculate a benchmark VaR against that portfolio. Each bank, as part of its daily reporting, should provide its VaR calculation to the regulators for comparison with the OFR benchmark. The OFR benchmark portfolio should include calculations for each product traded at the banks. Variances between the bank's model and the OFR standard should be explained by the reporting banking entity.

Risk Factor Sensitivities, and Risk and Position Limits
We see some serious omissions from the list of examples of risk factor sensitivities for several products. For example, Equity Derivatives lack any reference to the various Greek risks (Delta, Gamma, etc.) inherent in all positions. Credit derivatives lack mention of recovery or default risk. It is **very** important that banking entities understand that they must provide **all** risk data for a given product, as this will be the only way for the Agencies to obtain a holistic picture of the banks' true risk profiles.

**Is the general calculation guidance effective and sufficiently clear? If not, what alternative would be more effective or clearer? Is more or less specific calculation guidance necessary? If so, what level of specificity is needed to calculate the quantitative measurement? What are the different calculation options and methodologies that could be used to reach the desired level of specificity? What are the costs and benefits of these different options? If the proposed calculation guidance is not sufficiently specific, how should the calculation guidance be modified to reach the appropriate level of specificity? For example, rather than provide this level of specificity in proposed Appendix A, should the Agencies instead make each banking entity responsible for determining the best method of calculating the quantitative measurement at this level of specificity, based on the banking entity's business and profile, which would then be subject to supervision, review, or examination by the relevant Agency?**

The specific guidance in the proposed Appendix A is adequate, subject to some modifications to the definitions that we discuss below. The Agencies should require each banking entity to

provide the metrics defined based on defined standards, as in the proposed Appendix A. It should not be left to each banking entity to determine the best method of calculating the quantitative measurement. We would expect the Appendix A standards to be refined as a result of this public comment process, but the statute is clear and the FSOC Study supports the intent that the regulators would define a common set of standard metrics. Over time, the Agencies will refine the measures as the data is assessed.

VaR, Stress VaR, and VaR Exceedance

VaR methodologies tend to vary across banking entities, leading to data sets that will be incomparable for the purposes of the Agencies. We propose that a standard calculation methodology be developed by the OFR. Similarly, a central repository for historical calculation data for each asset should be created and administered by the OFR for the purposes of standard calculation across the industry.

Specifically, we recommend the use of historical Value-at-Risk with a 1-year and 5-year look back, for which a daily 95 and 99 VaR should be given. An additional requirement could show regular VaR with exponential down-weighting factors of 0.97 and 0.99 (daily 95 and 99 VaR results given in both cases).

Furthermore, we caution the Agencies against providing inappropriate freedom to banking entities in their development of metrics regimes. Not only will this promote extremely incomparable data, but additionally this is an area where banking entities have proven to be inadequate with respect to internal governance.

Comprehensive Profit and Loss, and Portfolio Profit and Loss

The Calculation Guidance for Comprehensive P&L contains a serious error:

> *General Calculation Guidance:* Comprehensive Profit and Loss generally should be computed using data on the value of a trading unit's underlying holdings, the prices at which those holdings were bought and sold, and the value of any fees, commissions, sales credits, **spreads**, dividends, interest income and expense, or other sources of income from trading activities, whether realized or unrealized.[121]

"Spreads" is an undefined and meaningless word in this capacity and should be removed. We would like to note that the description of Comprehensive P&L in Appendix A states that this metric "should generally equal the sum of the trading unit's (i) Portfolio Profit and Loss and (ii) Fee Income," but the word "spreads" is not included in the description of either of those component parts.

Spread Profit and Loss

[121] NPR at 68.958 (emphasis added).

Outside of the most liquid and transparent markets, the Calculation Guidance for this measure is largely nonsensical. The concept of "turnover" is not applicable to most derivatives markets. Further, there is no practical way to accurately and consistently identify who initiated a given trade for the purposes of this calculation, and the guidance for bid/offer spreads in illiquid markets amounts to "just make it up."

Of course, the nature of illiquid markets is that there is no way to collect good data about trading patterns. The idea communicated by this Guidance is that the Agencies would prefer garbage to be reported, as opposed to nothing at all. We see this as yet another example of the pure impracticality of allowing banking entities to trade illiquid products within the framework of this Rule.

Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss
30 days or even 90 days is insufficient for estimating these statistics, which can be demonstrated by any computational package thus: Take a Student-t distribution with say 3 degrees of freedom, take a sample size of 30 or 60 or 90, and compute the sample skewness and kurtosis. Do this 10,000 times for each window length and view the histogram of the resulting estimates. It will be observed that there is not a tight band around the "true" value.

We suggest using 2 years of daily data as an appropriate calculation period for these measures.

Comprehensive Profit and Loss Attribution
The mention of "customer spreads, bid-ask spreads" is extremely unclear in the Guidance. "Customer spreads" is neither an understood concept, nor is its intended meaning included anywhere in this Proposed Rule. Further, we are unclear how "bid-ask spreads" would be meaningfully separated from either trade P&L (or P&L resulting from closed-out buy/sell pairs of identical transactions) or mark-to-market gains or losses from new trading positions on the books. We propose the removal of both of these terms from the Calculation Guidance.

**If the proposed calculation guidance is overly specific, why is it too specific and how should the guidance be modified to reach the appropriate level of specificity? Is the general calculation guidance for the measurement consistent with how banking entities currently calculate the quantitative measurement, if they do so? If not, how does the proposed guidance differ from methodology currently used by banking entities? What is the purpose of the current calculation methodology used by banking entities?**

The general Calculation Guidance is consistent with current industry practice for managing risk, preparing profit and loss attribution, and preparing financial reports. Additionally, most of these metrics are required as evidence of the effectiveness of the internal controls around financial reporting.

**What operational or logistical challenges might be associated with performing the calculation of the quantitative measurement and obtaining any necessary informational inputs?**

Realistically, there should be no logistic or operational challenges with respect to these measurements, beyond those that already exist in banking entities. We would like to reiterate that all of the relevant data is already being collected and analyzed within banking entities, and this rule's requirements should be exceedingly easy to meet.

We can see a number of potential complications due to the poor design or implementation of current practices (for instance, varying VaR calculation methodologies across business units in a banking entity). The Agencies must be diligent in ensuring they receive the highest quality data from banking entities in light of such challenges.

**Is the quantitative measurement not calculable for any specific type of trading unit? If so, what type of trading unit, and why is the quantitative measurement not calculable for that type of trading unit? Is there an alternative quantitative measurement that would reflect the same trading activity but not pose the same calculation difficulty? Are there particular challenges to documenting that a specific quantitative measurement is not calculable?**

We do not believe any of the quantitative measures are not calculable by any of the firms engaged in the activities permitted under the statute.

**Is the quantitative measurement substantially likely to frequently produce false negatives or false positives that suggest that prohibited proprietary trading is occurring when it is not, or vice versa? If so, why? If so, what alternative quantitative measurement would better help identify prohibited proprietary trading?**

We have proposed that **none** of these quantitative measurements should be seen as, or understood to be, a dispositive tool for identifying prohibited proprietary activity. Therefore, the problems of false-positives or false-negatives should not be an issue.

Taken together, these quantitative measurements serve to provide a general overview of the types of risks and activities conducted at a banking entity, and we again caution the Agencies to maintain realistic expectations about what information these measures can provide.

**Should the quantitative measurement better account for distinctions among trading activities, trading strategies, and asset classes? If so, how? For example, should the quantitative measurements better account for distinctions between trading activities in cash and derivatives markets? If so, how? Are there any other distinctions for which the quantitative measurements may need to account? If so, what distinctions, and why?**

Yes, there are other distinctions for which the quantitative measurements should account. For distinctions among asset classes, particularly among liquid and illiquid asset classes, enhanced reporting and disclosure should be required to reflect the uncertainty of the measures based on data from these markets.

For trading strategies that rely heavily on models to calculate risk exposures (e.g., correlation trading portfolios, etc.), additional disclosures in the Risk Factor sensitivities should be required to evaluate the reliability of the model-driven reporting.

Similarly, additional disclosure in the Risk Factor Sensitivity reporting should be required to evaluate the quality of the metrics for portfolios that have exposure to assets having value that is model-derived. This requirement can be linked to the Level 1, 2 or 3 classifications used by the firm to report its positions in its financial statements. For example if total Risk Factor sensitivities contain exposure from Level 3 (model-derived valuation) assets, an additional disclosure identifying the Risk Factor Sensitivity to those assets should be required.

**Should the quantitative measurement be required to be reported for all trading activities, only a relevant subset of trading activities, or not at all?**

The quantitative measurements must be required for **all** trading activities. Determining the relevant subset without enough historical information about the efficacy of the requested information is not warranted.

**Does the quantitative measurement provide useful information as applied to all asset classes, or only a certain subset of asset classes? If it only provides useful information for a subset of asset classes, how should this issue be addressed? How beneficial is the information the quantitative measurement provides for this subset of asset classes?**

The quantitative measurements do not provide useful information as applied to all asset classes. Less reliance should be placed on the quantitative measures for those asset classes that trade in relatively illiquid markets since the data on which the calculations are based may be unobservable, model-driven or stale. Absent a metric to measure the quality of the underlying data, these measures should be subject to greater scrutiny, and the impact of these data should be clearly disclosed.

The measures that are less beneficial for monitoring these asset classes are:

- VaR, Stress VaR, and VaR Exceedance
- Fee Income and Expense
- Pay to Receive Ratio

Spread Profit and Loss
Spread P&L only produces useful data for very liquid, transparent assets. This issue should be addressed by declaring illiquid assets to be prohibited trading activities for covered banking entities. The permissible options for disclosing this calculation are entirely subjective and unreliable.

**Do any of the other quantitative measurements provide the same level of beneficial information for this subset of asset classes? Should the quantitative measurement be required to be reported for all asset classes, only a relevant subset of asset classes, or not at all?**

The quantitative measures should be required to be reported for all asset classes. However, disclaimers and disclosures regarding the quality of the underlying data for the metrics listed in the first part of this question, including the estimated impact on the resulting metrics, should be required.

**Is the calculation period effective and sufficiently clear? If not, what alternative would be more effective or clearer?**

VaR, Stress VaR, and VaR Exceedance
Historical VaR calculations should be made with both a 1-year and 5-year look back.

Risk Factor Sensitivities, and Risk and Position Limits
To avoid inappropriate window-dressing at calculation time, risk factor sensitivities should be calculated several times per day, and averaged to produce the reported daily number.

Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss; Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss
30 days or even 90 days is insufficient for estimating these statistics, which can be demonstrated by any computational package thus: Take a Student's t-distribution with say 3 degrees of freedom, take a sample size of 30 or 60 or 90, and compute the sample skewness and kurtosis. Do this 10,000 times for each window length and view the histogram of the resulting estimates. It will be observed that there is not a tight band around the "true" value. We suggest using 2 years of daily data as an appropriate calculation period for these measures.

**How burdensome and costly would it be to calculate the measurement at the specified calculation frequency and calculation period? Are there any difficulties or costs associated with calculating the measurement for particular trading units? How significant are those potential costs relative to the potential benefits of the measurement in monitoring for impermissible proprietary trading? Are there potential modifications that could be made to the measurement that would reduce the burden or cost? If so, what are those modifications? Please quantify your answers, to the extent feasible.**

Following the financial crisis of 2008, it was our collective experience as industry professionals that many banking entities realized that their fragmented risk management systems were a substantial problem that needed to be addressed. In the years following the crisis, substantial efforts were made at banks, both domestic and foreign, to consolidate risk models, build the appropriate software infrastructure, and facilitate oversight by senior management and the risk departments. Efforts like these were undertaken at many banks, and these efforts should flow easily into the metrics that the Agencies are requesting for reporting in this Rule. Any claim that such an implementation would be too costly to perform ignores the fact that similar initiatives were launched, planned, and executed in the wake of the 2008 crisis. We acknowledge that even given such efforts, there will still need to be tweaks and adjustments made to account for the reporting demanded by the Volcker Rule. They should not, however, be so substantial as to be burdensome. Indeed, the need for new, independent efforts to build firm-wide risk systems to comply with this Rule should be seen as an indication of serious shortcomings in current risk regimes. Implementing these reporting requirements will only promote the safety and soundness of the banking industry at large.

**Question 175. In light of the size, scope, complexity, and risk of covered trading activities, are there certain types of quantitative measurements that will not be appropriate for some types of banking entities, desks, or levels?**

All the quantitative measures that rely on historical pricing data in illiquid markets have a limited usefulness. For example, VaR calculation may be a poor measure of risk for an illiquid bond portfolio. VaR back-testing analysis performed by the banks and provided to the regulators should be incorporated into the required metrics to assist the regulators in evaluating the quality of the quantitative measures they will be relying on.

**If so, would it be appropriate to require only certain quantitative measurements for such banking entities, desks, or levels?**

No. The full set of reporting metrics should be required.

**Question 176. How might the number of quantitative measurements impact behavior of banking entities? Is there a cost of requiring more quantitative measurements, such as the cost of increased uncertainty regarding the combined results of such quantitative measurements? To what extent and in what ways might uncertainty as to how the quantitative measurements are applied and evaluated impact behavior?**

See the Question above for further discussion.

**Question 177. Is the overview of permitted market making-related activities and prohibited proprietary trading proposed in Appendix B accurate? If not, what alternative**

**overview would be more accurate? Does the overview appropriately account for differences in market making-related activities across different asset classes? If not, which type of market making-related activity does the overview not sufficiently describe or account for?**

It is clear that much of this Proposed Rule has been based on the model of highly liquid exchange-traded equity markets. Although this is a great simplifying factor, it is a tremendously unrealistic one. The Market Making Commentary in Appendix B of the Proposed Rule is an example of how this rule tends to account for only the most liquid and transparent markets (i.e., listed equities, U.S. Treasuries), and fails to accurately describe market making in most illiquid or OTC markets. We find this particularly troubling, given that this benchmark asset type was not considered to be a contributor to the most recent crisis, and it is not expected to present significant opportunities to evade the Volcker Rule. **Illiquid markets were and continue to be havens of risky and irresponsible activity, yet they are largely forgiven throughout this Rule.**

We have submitted an alternative Market Making Commentary, which is attached as *Annexure C* to this comment letter. Our major concern in providing alternative language was to address the excessive flexibility in the current Commentary's interpretation of illiquid products. We have emphasized throughout this comment letter that *the potential for proprietary trading in illiquid markets is massive*. An unfortunate consequence of the generalized language in this Commentary and throughout the Proposed Rule may be the shift of risky practices out of liquid and transparent markets into the less regulated illiquid and OTC products. We have provided alternative language with more stringent requirements for illiquid and complex products, such that they are held to the standards outlined in this rule more closely.

We outline below the specific issues that we attempted to address in our alternative commentary.

1. *Removal of Bid/Ask Spreads as Legitimate Trading Revenue*

Revenue generated by capturing bid/ask spreads is functionally identical to gains from price movements in the underlying securities. We reject the notion that this is either indicative of bona fide market making or practically feasible to implement, and have removed this from the list of indicia.

2. *Revenue per Unit of Risk Taken, Consistent Profitability, and Earnings Volatility*

This is an extremely important and necessary factor that will provide invaluable information about the nature of the trading activity. We have seen a tremendous amount of concern by

banking entities and their lobbyists regarding this particular point.[122] Their concern serves to illustrate the strength of these factors in identifying prohibited activity. We would like to emphasize that trading books with sufficiently low risk and sufficiently consistent customer-servicing activity will be consistently able to adequately demonstrate the qualities listed above.

3. *Reasonably Expected Near Term Customer Demands*

We reject the notion that an estimation of the "near-term demands of clients" is a meaningful consideration in illiquid markets. The question of "if" there will be demand (near-term or otherwise) is of much greater importance than the degree of such demand, should it exist at all. Regardless of whether such demand is resulting from or in anticipation of client activity, the Rule serves to allow banking entities to warehouse significant illiquid risk for extended periods of time *because* that is just how illiquid markets work. We see this as a grievous logical error that should be stricken from the Commentary and seriously reconsidered by the Agencies in general. This issue is discussed in greater detail in Question 87.

**Question 178. Is the requirement that a market maker engaged in market making that is executed on an exchange or an organized trading facility must be a registered market maker, provided the relevant exchange or organized trading facility provides the ability to register, appropriate, or is it over- or under-inclusive?**

For all markets where registration is a possibility, of course it would be reasonable to require that all market participants expecting to rely on this exemption be registered. Additionally, in those markets where registration is not yet a possibility, traders should be required to demonstrate adherence to the same, or commensurate, standards as apply to registered markets. This demonstrates a commitment to a high standard of practice, and moves to "avoid a 'lowest common denominator' framework" as was specified by Senator Merkley[123] in his explanation to Congress. It should be mandatory for all trading that seeks to use this exemption to be performed on an exchange or other organized trading facility. For further discussion, please see Question 95.

**Question 179. With respect to market making that is executed on an exchange or an**

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[122] *See, e.g.*, SIFMA & Oliver Wyman, *supra* note 56, at 10 ("Many elements of the compliance regime in the proposed rule seem to be based on an assumption that market making functions should show consistent revenue, risk taking, and trading patterns, both over short time periods (day to day) and across different periods of market conditions. In both more and less liquid markets, customer flows are often 'lumpy' (e.g., via facilitating block trades), and volatile risk-taking and revenue are natural consequences for market makers. In addition, market conditions – and the way market makers both serve customer needs and manage their own risks – can shift substantially over time.").

[123] 156 Cong. Rec. S5893 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("In coordinating the rulemaking, the Council should strive to avoid a 'lowest common denominator' framework, and instead apply the best, most rigorous practice from each regulatory agency.").

**organized trading facility, what potential impact or unintended consequences might result from limiting the market making exemption to registered market makers when the relevant exchange or organized trading facility registers market makers?**

It would be reasonable to expect that banking entities that are not currently registered as market makers, but seek to make use of the market making exemption, will apply for registration as a consequence of this Rule. It is not clear to us that such registration presents extensive requirements or sufficient barriers to entry to merit consideration as important in the context of this Rule.

**Would such a requirement result in any potential decrease in the passive provision of liquidity by the submission of resting orders? Do you anticipate that any such decrease would be exacerbated in times of market stress? If yes, please describe the impact on liquidity and the marketplace in general. Please discuss whether and how any potential decrease in liquidity could be mitigated. In addition, would such a requirement result in additional costs that would be borne by market participants purchasing and selling on an exchange or organized trading facility? Please identify and discuss any other additional costs. Please discuss whether and how any such consequences can be mitigated.**

In general, we find the extremely vocal portents by covered banking entities and industry lobbyists about this Rule's effects on the provision of liquidity to be wildly overblown. We hope that the Agencies keep the self-interested incentives of such concerned parties in mind when considering their comments, and weigh such concerns against the overall intentions of the Rule.

The requirements for registration as a market maker are generally very basic and uncontroversially responsible: demonstrate adequate capital requirements, be in good standing with self-regulatory agency, etc. It is difficult to see how meeting such requirements would either meaningfully deter substantive market participants from becoming registered, or provide additional risk to markets at large. Liquidity should not be a consideration with respect to this issue. It is our general opinion that markets with existing exchanges and organized trading facilities will be minimally impacted by the effects of this Proposed Rule, particularly with respect to liquidity and transparency.

**<u>Question 180</u>. In addition to benefits discussed in the Supplementary Information, are there other benefits that would be achieved by requiring that a market maker be registered with respect to market making on an exchange or an organized trading facility?**

As discussed in Question 179, this requirement demonstrates a commitment to higher standards of activity.

**Is there a way to amplify these benefits? Could these benefits be realized through alternative means? If so, how?**

Requiring that all products transact through exchanges or organized trading facilities would amplify these benefits.

**Question 183. Is there any specific element of market making-related activity that the overview does not take into account in its description of market making? If so, how should the overview account for this element? Are there any descriptions of market making-related activity in the overview that should not be considered to be market making-related activity? If so, why? Is there any specific element of prohibited proprietary trading activity that the overview does not take into account in its description of prohibited proprietary trading? If so, how should the overview account for this element? Are there any descriptions of prohibited proprietary trading activity in the overview that should not be considered to be prohibited proprietary trading? If so, why?**

As discussed in Question 177, the Appendix B Commentary fails to accurately account for illiquid or OTC products. These concerns are addressed in the alternative commentary we have provided in *Annexure C*.

**Question 184. Are each of the six factors specified for helping to distinguish permitted market making-related activity from prohibited proprietary trading appropriate? If not, how should they be changed, and why? Should any factors be eliminated or added? If so, which ones and why?**

• *Trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues;*

We see this as an important factor, but unfortunately this will be impossible to monitor or enforce in illiquid markets that trade entirely on a bid/ask spread basis. For further discussion of this issue, please see Question 96.

• *Trading activity in which a trading unit (i) generates only very small or very large amounts of revenue per unit of risk taken; (ii) does not demonstrate consistent profitability; or (iii) demonstrates high earnings volatility;*

This is an extremely important and necessary factor that will provide invaluable information about the nature of the trading activity. We have seen a tremendous amount of concern by banking entities and their lobbyists regarding this particular point.[124] Their concern serves to

[124] *See, e.g.*, SIFMA & Oliver Wyman, *supra* note 56, at 10 ("Many elements of the compliance regime in the proposed rule seem to be based on an assumption that market making functions should show consistent revenue, risk taking, and trading patterns, both over short time periods (day to day) and across different periods of market conditions. In both more and less liquid markets, customer flows are often 'lumpy' (e.g., via facilitating block

illustrate the strength of these factors in identifying prohibited activity. We would like to emphasize that trading books with sufficiently low risk and sufficiently consistent customer-servicing activity will be consistently able to adequately demonstrate the qualities listed above.

• *Trading activity in which a trading unit either (i) does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to provide liquidity services, or (ii) holds principal positions in excess of reasonably expected near-term customer demands;*

This is an important and necessary factor, but suffers from lack of enforceability. We would encourage the Agencies to specify the qualities of an applicable "trading system" and require that all permitted activity be conducted within such a system to facilitate monitoring of trading activity.

• *Trading activity in which a trading unit routinely pays rather than earns fees, commissions, or spreads;*

This is an important and necessary factor, despite the inapplicability to illiquid markets wherein bid/offer spreads are indistinguishable from proprietary activity.

• *The use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.*

This is an extremely important and necessary factor. Please see Questions 87, 97, and 113 for further discussion of this issue. We propose removal of the word "primarily" from this sentence, since banks will surely seek to abuse this weakness of language. Additionally, it should be stressed throughout the Final Rule that explanatory facts and circumstances **do not** apply when considering this factor in practice.

**Could any of the proposed factors occur as a result of the banking entity engaging in one of the other permitted activities (e.g., underwriting, trading on behalf of customers)? If so, would the facts and circumstances that the Agencies propose to consider be sufficient to determine and verify that the banking entity is not engaged in prohibited proprietary trading? If not, how should this issue be addressed?**

A footnote[125] in the Supplementary Information makes the obvious statement that explanatory

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trades), and volatile risk-taking and revenue are natural consequences for market makers. In addition, market conditions–and the way market makers both serve customer needs and manage their own risks–can shift substantially over time.").

[125] *Id.* at 68,891 n.201 ("The proposed commentary does not contemplate explanatory facts and circumstances for the compensation incentives factor, given that the choice of compensation incentives provided to trading personnel is under the full control of the banking entity.").

facts and circumstances could not reasonably exist to explain compensation incentives that are inconsistent with the Proposed Rule. Acknowledgement of this fact should be made explicit in the Rule text itself, which currently allows for explanatory facts and circumstances regarding all of the market making criteria, including compensation incentives.

**Question 185. Are the facts and circumstances that would be used to determine whether a banking entity's activities satisfy a certain factor appropriate? If not, how should they be changed, and why? Should any be eliminated or added? If so, which ones, and why?**

Please see our proposed alternative to the Appendix B Commentary attached as *Annexure C* to this letter.

**Question 187. What are the potential benefits and costs of incorporating into the proposed rule one or more numerical thresholds for certain quantitative measurements that, if reported by a banking entity, would require the banking entity to review its trading activities for compliance and summarize that review to the relevant Agency?**

In general, we believe that numerical thresholds will be useful to the Agencies in guiding their own operational techniques for monitoring compliance. We encourage the Agencies to develop such thresholds and keep detailed records on the frequency and degree to which they are exceeded. A pattern of regular or excessive breaching of such limits should be treated with penalties and increased scrutiny of all trading activities.

We would caution, however, against incorporating such thresholds directly into the language of the Rule for several reasons.

First, we see explicit targets and numerical boundaries as easily abused and evaded by banking entities. In light of the many creative structures that banks use to evade accounting and tax rules, our collective experience overwhelmingly confirms that risk managers at banking entities are indeed *uniquely capable of massaging data such that it avoids triggering increased oversight*. In light of the extensive explanation of prohibited vs. permitted activity throughout the balance of the Proposed Rule, it is clear that banking entities have sufficient guidelines to determine the permissibility of future activities. The thresholds used by the Agencies to prompt additional investigation should be known by the Agencies alone.

Furthermore, due to the constantly evolving nature of financial markets, having hard-coded numerical thresholds in the Proposed Rule would provide extensive complication in the future as these thresholds would need to be constantly revised and updated. We see significant risk and limited advantage to including hard numerical values within the Rule.

**Would such thresholds provide useful clarity to banking entities and/or market participants regarding the types of trading activities that merit additional scrutiny?**

The clarity provided would be useful primarily in evasion of such thresholds.

**Should numerical thresholds be used for any purposes other than highlighting trading activities that should be reviewed, the results of which would be reported to the relevant Agency? If so, for what purpose, and how and why?**

The agencies should keep records on frequency and degree to which banking entities are exceeding such thresholds. A regular pattern of excessive breaching of such limits should be treated with penalties and increased scrutiny of all trading activities.

**Question 188. For which of the relevant quantitative measurements might it be appropriate and effective to include a numerical threshold that would trigger banking entity review and explanation? How should a numerical threshold be formulated, and why? Should a numerical threshold for a single quantitative measurement be applied individually, or should the threshold instead be triggered by exceeding some combination of numerical thresholds for different measurements? For any particular threshold, what numerical amount should be used, and why? How would such numerical amount be consistent with a level at which further review and explanation is warranted? Should the amount vary by asset class or other characteristic? If so, how?**

For further discussion, please see Question 187.

**Question 189. For each of the following illustrative examples of potential thresholds, is the threshold formulated effectively? If not, what alternative formulation would be more effective? Should the threshold formulation vary by asset class or other characteristic? If so, how and why? If the threshold was utilized, what actual numerical amount should be specified, and why? How would such numerical amount be consistent with a level at which further review and explanation is warranted? Should the numerical amount vary by asset class or other characteristic? If so, how and why?**

For related comments, please see Question 187.

**Question 190. Is the manner in which the proposed rule implements the limitations of section 13(d)(2) of the BHC Act effective and sufficiently clear? If not, what alternative would be more effective and/or clearer?**

Based on *current* banking practice, market making, underwriting, hedged trading, and the rest of the permitted activities listed in Section 619(d)(1) all run afoul of the limitation contained in Section 619(d)(2)(A)(i). That limitation states that banking entities may not rely on any Volcker Rule exclusion if doing so would result in a material conflict of interest with "customers." Depositors should fall within the definition of "customers" since banks provide them with

depository services. Virtually all banking entities that engage in market-making and other exempted activities fund these activities, at least indirectly, with depositors' funds. However, depositors are never compensated for the usage of their funds when banks earn money from proprietary positions, which is a conflict of interest.

When depositors post money at banks, that money does not remain in a vault. Rather, it is utilized by banking entities to make loans, pay off expenses, and otherwise create an infrastructure through which to *conduct proprietary trades*. Thus, banks stand to gain from the leverage provided to them by depositors. Unfortunately for depositors, this provision of leverage remains uncompensated. Congressman Keith Ellison cogently recognized this point during the Congressional House Committee on Financial Services' recent hearing on the Volcker Rule:

> In the absence of something like Volcker Rule, we have a head I win, tails you lose system in which, if I'm a bank I can go out and buy mortgage-backed securities ("Triple A rated"). . . they make a bunch of money, I keep that, I do not give that to those depositors, [whose money] I use . . . But if I lose a bunch of money, I'm coming to the taxpayer to save me. And it seems so unfair.[126]

Burton's Legal Thesaurus states that a "conflict of interest" exists where a party faces a divergence of interests with respect to clients.[127] We know of no bank that repays FDIC-insured depositors for usage of their money in the form of participation interests on the proceeds from proprietary trading. This is an exploitative situation wherein the resources of one party are utilized by another, without just compensation—a clear "divergence of interests." Thus, simple logic dictates that depositors must be granted some monetary participation in any gains achieved by a banking entity from exempted activities like market making. Absent such a participation, Section 619(d)(2)(A)(i) would bar <u>all</u> proprietary trading by covered banking entities.

**<u>Question 191</u>. Is the proposed rule's definition of material conflict of interest effective and sufficiently clear? If not, what alternative would be more effective and/or clearer?**

Even if the Agencies decline to adopt this interpretation, we have various other concerns with the Proposed Rule's implementation of the Section 619(d)(2)(A)(i) backstop. For instance, the Agencies have impermissibly interposed disclosure and information barriers into the Proposed Rule as curative measures to address conflicts-of-interest. Section 619(d)(2) contains no mention of information barriers or disclosure, and it appears that the Agencies have added these components into the conflict-of-interest backstop without any statutory justification.

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[126] U.S. House, Committee on Financial Services, *Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation*, Hearing, Jan. 18, 2012, *available at* http://mfile3.akamai.com/65722/wmv/sos1467-1.streamos.download.akamai.com/65726/hearing011812.asx.

[127] William C. Burton, Burton's Legal Thesaurus (2007).

There is evidence that Congress purposely excluded disclosure and information barriers as rehabilitative measures to address conflicts of interest. First, the Congressional Record relating to the passage of Section 619 is devoid of any mention of these concepts. Second, the legislative intent behind Section 621, which is indirectly related to and was passed alongside Section 619, is illuminating on this point. Senator Levin expressly rejected the usage of disclosure as potentially curative of conflicts of interests in asset-backed security underwritings:

> [A] firm that underwrites an asset-backed security would run afoul of the provision if it also takes the short position in a synthetic asset-backed security that references the same assets it created. In such an instance, even a disclosure to the purchaser of the underlying asset-backed security that the underwriter has or might in the future bet against the security will not cure the material conflict of interest.[128]

Congress had the opportunity to include disclosure and information barriers provisions into Section 619, and it chose not to do so. The Agencies must follow suit. An administrative agency exceeds its authority when it considers regulatory options that have been purposely dismissed by Congress.[129]

**Question 192. Is the proposed definition of material conflict of interest over-or under-inclusive? If so, how should the definition be broader or narrower? Is there an alternative definition that would be appropriate? If so, what definition? Why would that alternative definition better define material conflict of interest for purposes of implementing section 13 of the BHC Act?**

Enforcement: Imposition of a Fiduciary Duty

The Proposed Rule's definition of conflict-of-interest is under-inclusive because it fails to sufficiently delineate the contours of what does and what does not constitute a conflict of interest. By creating a vague standard with little direct precedential value, the Agencies have not provided market participants with any usable guidelines with which to conform their conduct. We propose that the Agencies redress this deficiency by imposing an explicit fiduciary duty on any banking entity relying on a Section 619(d) exemption. Such an imposition is justified on two grounds:

i. the requirement that permitted proprietary trading be client-oriented is tantamount to the imposition of a fiduciary duty, and

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[128] 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).

[129] *See Levine v. Apker*, 455 F.3d 71, 80 (2d Cir. 2006) ("[W]e will not defer to an agency's interpretation that contravenes Congress' unambiguously expressed intent.").

ii. the Section 619(d)(2)(A)(i) ban on conflicts of interest in permitted activities imposes a heightened relationship of trust between a bank and its client, consistent with a fiduciary standard.

*i. Client-oriented Activities*

In a normal arms-length transaction, a banking entity must only satisfy a relatively simple, anti-fraud standard in its dealings with clients and counterparties. In such transactions it is understood that the parties have divergent interests, and that one party does not safeguard the interests of the other. This arms-length scenario does **not** apply to transactions permitted under Section 619(d). That Section requires that any banking entity performing permitted proprietary trading activities meet a fiduciary standard with respect to its clients.

The Congressional Record reveals that the purpose behind the Section 619(d) exemption was to allow proprietary trades only if they were "safer, client-oriented financial services."[130] This focus on client-oriented services is markedly different from the typical arms-length relationship that undergirds most banking activities. In an arms-length transaction, the bank's focus is on its own bottom line. In a client-oriented transaction, the bank's focus must be on the client's bottom line; otherwise that transaction would not be "client-oriented." In other words, the legislative intent was to force banks conducting exempted activities to align their interests with those of their clients.

The client-oriented duty that is imposed on banking entities relying on Section 619(d) can fairly be described as a fiduciary duty. Black's Law Dictionary defines "fiduciary duty" as "a duty obligating a fiduciary (as an agent or trustee) to act with loyalty and honesty and in a manner **consistent with the best interests of the beneficiary**."[131] That is, a fiduciary must promote the client's best interests. Similarly, as per Congressional intent, a banking entity operating under one of the Section 619(d) exemptions must also promote the client's best interests. Thus, Section 619(d)'s emphasis on the client's best interest is entirely consistent with the concept of fiduciary duty. Indeed, concern for another's interests ahead of one's own is the hallmark characteristic of a fiduciary duty.

*ii. Heightened Relationship of Trust*

The Volcker statute also imposes a fiduciary standard by operation of the plain language of the conflict of interest backstop contained in Section 619(d)(2)(A)(i). That provision holds that activities otherwise permitted under Section 619(d) are banned if they would result in a "conflict of interest." This restriction contemplates a heightened relationship of trust between a bank and its client, which is consistent with a fiduciary standard.

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[130] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).
[131] Merriam-Webster's Dictionary of Law (1996).

The default rule for banks executing proprietary trades is that the bank is free to have gross conflicts of interest with its clients (provided there is no fraud). Section 619(d)(2)(A)(i) changes this default rule with respect to Section 619(d) exempted activities. By imposing a limitation on conflicts of interest, Section 619(d)(2)(A)(i) imposes a **heightened burden** on bank engaging in exempted activities. Under this heightened burden, a bank must align its interests with those of clients, so as to avoid material conflicts of interest. This alignment of interests, which is imposed by statute, is suggestive of a close, trusting relationship between the bank and its clients. As discussed above, the legislative history confirms that Congress intended to impose just this type of close, trusting relationship in this context. Case law holds that where clients expect a heightened level of trust from financial services providers, a fiduciary duty is imposed.[132] That is, the existence of a relationship of trust can give rise, *sua sponte*, to a fiduciary duty benefiting the client. Thus, it can be argued that Section 619(d)(2)(A)(i)'s limitation on conflicts of interest creates a fiduciary duty for any banking entity conducting exempted activities under Section 619(d).

This proposition is not unprecedented. In other areas of law, bans on conflict of interest go hand-in-hand with fiduciary duty. For example, in the context of corporate law, the fiduciary duty placed on a company's director requires a purposeful alignment of interests by that director. The director must refrain from privileging his personal financial interest over that of the corporation in making decisions.[133] In other words, the director must not allow a conflict of interest to taint his actions, as that would be a breach of fiduciary duty. Similarly, an attorney's fiduciary duties severely limit her ability to be involved in matters giving rise to a conflict of interest, given that a client's interest must be held as paramount.[134] Analogously, the Section 619(d)(2)(A)(i) conflict of interest limitation also requires an alignment of interests between bank and client, and is therefore consistent with the concept of fiduciary duty.

Practically speaking, a fiduciary duty would benefit both banks and the regulators charged with ensuring compliance with the Volcker Rule. The fiduciary standard is backed by centuries of interpretive common law. This well-established body of precedent would serve as an objective yardstick with which banking regulators and compliance officers could measure bank conduct. We are aware that Section 913 of the Act has raised the possibility of a uniform fiduciary

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[132] *See Breakaway Solutions, Inc. v. Morgan Stanley & Co.*, No. Civ. A. 19522, 2005 WL 3488497, at *2 (Del. Ch. Dec. 8, 2005) ("To the extent that underwriters function, among other things, as expert advisors to their clients on market conditions, a fiduciary duty may exist."). *See also EBCI Inc. v. Goldman, Sachs & Co.*, 19, 832 N.E.2d 26, 31 (2005) ("[A] cause of action for breach of fiduciary duty may survive, for pleading purposes, where the complaining party sets forth allegations that, apart from the terms of the contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone.").

[133] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) ("Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally").

[134] ABA Model Rules of Prof'l Conduct R. 1.7.

standard for all financial advisers. Still, the Agencies should recognize that Section 619 imposes a fiduciary duty on banks for any Section 619(d) permitted activities, irrespective of and separate from Section 913.

Enforcement: Limitation on Banking Entity Size

The conflict of interest limitation can also be seen as a jurisdictional justification for the imposition of size limits on banking entities that seek to conduct covered activities under one of the exemptions. Opportunities for front running abound in larger organizations. At larger banks, it is easier to couch front running as mere fortuitous gains derived from independently acquired information. This kind of obfuscation is more difficult in smaller banks, since customers are likely to have more visibility into a smaller bank's operations. As the J.P. Morgan/Sigma case demonstrates,[135] the larger the bank, the easier it is for that bank to claim that assertedly conflicted actions were justified by the presence of information barriers. We recommend that the Agencies impose a size restriction on banking entities relying on a proprietary trading exemption. A suitable limitation would be $5 billion in trading assets and liabilities, which is the Proposed Rule's threshold for enhanced record-keeping duties. Such a restriction would be one of the most effective ways—certainly more effective than disclosure or information barriers—for banks to avoid conflicts of interest with clients.

Enforcement: Disgorgement of Principal Gains

The conflicts of interest provision justifies automatic disgorgement of money that banks earn from price movements while conducting Section 619(d) permitted activities.[136]

The Proposed Rule strains logic by claiming that "the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests would not be deemed a 'material' conflict of interest with respect to [Section 619(d) permitted] transactions." Frankly, this makes no sense. The fact that a buyer and seller are on opposite sides of a transaction **necessarily** means that they have a significant conflict simply because a typical trade between a buyer and seller is a zero-sum game. In fact, the two parties in a trade are materially[137] conflicted in their objectives whenever there is a possibility that one side will win, and the other side will lose on the transaction. The only permissible way that a bank and a client could be on different side of a transaction without there being a material conflict of interest is if the bank were to lose on the transaction **every time**. This presents the Agencies with two options:

1. Mandate that the Section 619(d) permitted activities can never be done if a banking entity is on one side of a transaction and its client is on the other side (in

[135] See *infra* text accompanying note 148.
[136] The tool of disgorgement is discussed above in the underwriting and market making section.
[137] Indeed, the prospect of gain (or loss) on a transaction is probably the most "material" aspect of any trade.

recognition of the fact that the bank will win sometimes, to the detriment of the client), or

2. Allow a bank and its client to be on opposite sides provided that the bank is required to disgorge to the client any profits made from the transaction. This would nullify the effects of the conflict.

It should be noted that the bank's fees for services would not be subject to disgorgement since there would be no conflict over such fees. The client has no legitimate right to the bank's fees for services rendered. However, the client certainly would have a right to claw back profits from price movements in retained principal risk.

**Question 194. Would the proposed definition of material conflict of interest lead to unintended consequences? If so, what unintended consequences and why? Please suggest modifications to the proposed definition that would mitigate those consequences.**

As discussed above, the current definition of material conflict of interest improperly dilutes this limitation's effectiveness, and opens up avenues for front-running and customer exploitation. Disclosure and information barriers serve as exceptions to a limitation (conflict of interest) on exemptions to a restriction (on proprietary trading). If the Agencies' goal was to inject as much complexity as possible into the simple idea that is the Volcker Rule, they have achieved it.

**Question 198. Please discuss the inherent conflicts of interest that arise from bona fide underwriting, market making-related activity, risk-mitigating hedging, or any other permitted activity, and provide specific examples of such inherent conflicts. Do you believe that such conflicts ever result in a materially adverse interest between a banking entity and a client, customer, or counterparty? How should the proposal address inherent conflicts that result from otherwise-permitted activities?**

For further discussion, please see Question 190.

**Question 199. Is the manner in which the proposed rule permits the use of disclosure in certain cases to address and mitigate conflicts of interest appropriate? Why or why not? Should additional or alternative requirements be placed on the use of disclosure to address and mitigate conflicts? If so, what additional and alternative requirements, and why? Is the level of detail and specificity required by the proposed rule with respect to disclosure appropriate? If not, what alternative level of detail and specificity would be more appropriate?**

Disclosure is an ineffective remedy for numerous reasons. First, disclosure has limited utility where the potential wrongdoer is the party that is given the responsibility of providing the relevant information to investors. If a banking entity has engineered a proprietary trade with the express intention of taking advantage of customers, it will not meaningfully disclose that fact.

Banks will only willingly disclose meaningless or benign information. In a recent speech at Fordham Law School, Securities and Exchange Commissioner Troy A. Paredes recognized that disclosure can be useless in some cases, especially where the sheer volume of the disclosed material militates against actual comprehension of risk.[138] Even where disclosed information is meaningful, the relevant bits of information may be buried in a sea of paper that would effectively pre-empt actual comprehension of risk by investors. For instance, in its investigation of Citigroup's Class V Funding III collateralized debt obligation (CDO), the Securities and Exchange Commission ("SEC") learned that Citigroup had disclosed to investors in its pitch book and offering circular that it had taken a short position in the underlying credit derivative.[139] The SEC nevertheless continued the investigation, which culminated in a $285 million settlement.[140]

Disclosure is particularly ineffective in illiquid markets because these markets typically feature information asymmetries or pricing obscurities. Banking entities with even the best of intentions simply may not have enough information to disclose material conflicts of interest. The example of Long Term Capital Management will demonstrate that even sophisticated parties may not be aware of or fully appreciate the risks involved in their own activities.[141]

Further, even if banking entities were able to identify and disclose conflicts of interest in their proprietary trading activities, their customers may not be able to appreciate or digest such disclosures. The savviest of institutional investors may not have sufficient resources or access to information to verify the contents of disclosure documents, especially within the context of highly illiquid markets. Many investors simply presume that disclosed information is accurate, relying on the underwriter's reputation as an information proxy.[142]

At § _.8(b)(1)(ii), the Proposed Rule further dilutes the impact of the conflict-of-interest backstop, by allowing disclosures to "negate**, or substantially mitigate,** any materially adverse effect on the client."[143] If the Agencies retain a role for disclosure as curative of conflicts of interest, despite the above-mentioned arguments, they should at the very least strike ", or substantially mitigate," out of § _.8(b)(1)(ii). Put simply, banks should be required to negate any materially adverse effects on clients, and not just "substantially mitigate" those effects. A

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[138] *See* Troy A. Paredes, Address at Twelfth Annual A. A. Sommer, Jr. Lecture on Corporate, Securities and Financial Law, Fordham Law School (Oct. 27, 2011) (speech given in Securities and Exchange Commissioner Paredes's individual capacity).

[139] *Sec. & Exch. Comm'n v. Citigroup Global Markets Inc.*, SEC Litigation Release No. 22134 (Oct. 19, 2011).

[140] *Id.* The Southern District of New York later rejected the SEC's application to confirm this paltry settlement figure, because such a confirmation would turn the courts into "an agent of oppression." *See SEC v. Citigroup Global Markets Inc.*, Case No. 11 Civ. 7387, slip op. at 15 (S.D.N.Y. filed Nov. 28, 2011).

[141] *See generally* Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (2001).

[142] Andrew T. Tuch, Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs 57 (Apr. 2011), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Tuch_37.pdf.

[143] Proposed Rule § _.8(b)(1)(ii) (emphasis added).

"substantial mitigation" standard would effectively condone minor-yet-materially adverse effects of conflicts of interest on banking clients. This interpretation is at odds with the customer-focused motivation behind the Volcker Rule.

**Question 200. Should the proposed rule require written disclosure to a client, customer, or counterparty regarding a material conflict of interest? If so, please explain why written disclosure should be required. Are there certain circumstances where written disclosure should be required, but others where oral disclosure should be sufficient? For example, should oral disclosure be permitted for transactions in certain fast-moving markets or transactions with sophisticated clients, customers, or counterparties? If oral disclosure is permitted under certain circumstances, should subsequent written disclosure be required? Please explain.**

As noted above, disclosure should not play any curative role vis-à-vis a conflicted transaction. However, at the very least disclosure should be written and meaningful. Oral disclosures have limited utility in court proceedings due to the Statute of Frauds and other evidentiary standards.

**Question 203. Should the proposed definition of material conflict of interest deem certain potential conflicts of interest to not be material conflicts of interest if a banking entity establishes, maintains, and enforces policies and procedures (other than information barriers) reasonably designed to prevent transactions, classes of transactions, or activities that would involve or result in a material conflict of interest? If so, for what types of potential conflicts? What policies and procedures would be appropriate? How would this approach be consistent with the purpose and language of the statute? Should such policies and procedures only be considered effective if they prevent the banking entity from receiving an advantage to the disadvantage of the client, customer, or counterparty?**

The Agencies should not rely on the presence of internal policies and procedures or any other subjective standard when it comes to negating the adverse effects of conflicts of interest. Instead, banks should be held to a strict liability standard under which they will be held responsible for any adverse effects to clients resulting from conflicted proprietary trading (or covered fund) activities. The mere presence or absence of written policies and procedures is immaterial to a client that suffers losses due to bank misconduct.

**Question 204. Are there any particular types of clients, customers, or counterparties for whom disclosure of a material conflict of interest should not be required under the proposal, consistent with the statute? Please identify the types of clients, customers, or counterparties for whom disclosure might not be necessary and explain. Why might disclosures be useful for some clients, customers, or counterparties, but not others? Please explain. What characteristics should a firm use in determining whether or not a client, customer, or counterparty needs a particular disclosure?**

As noted above, disclosure should not play any curative role vis-à-vis a conflicted transaction. However, if it is allowed, it should be required with respect to all affected clients, customers and counterparties.

**Question 206. Are there circumstances in which disclosure might be impracticable or ineffective? If so, what circumstances, and why?**

For further discussion, please see Question 199.

**Question 207. Is the manner in which the proposed rule permits the use of information barriers to address and mitigate conflicts of interest appropriate? Why or why not? Should additional or alternative requirements be placed on the use of information barriers to address and mitigate conflicts? If so, what additional and alternative requirements, and why?**

Information barriers also have limited usefulness in curing conflicts of interest. The NPR notes that information barriers are currently used as a means to address conflicts of interest in other securities law contexts. The implication is that these information barriers are effective tools in promoting a culture in which the interests of investors are paramount and sensitive information is not exploited for gain. However, despite the existence of these barriers, front running occurs routinely. Every few months the financial pages are replete with stories of how so-called "rogue traders" are able to circumvent information barriers and other controls to lose billions of dollars in highly risky transactions, at the expense of clients.[144] Academics have also amassed empirical evidence questioning the efficacy of information barriers.[145] Such studies have found that even where information barriers are erected, regulators are routinely unaware of when such barriers have been breached.[146] Information barriers are a regulatory tautology, in that regulated entities are essentially asked to police themselves and to report non-compliance.[147]

In some cases, information barriers actually undermine the efficacy of disclosure as a tool to cure conflicts of interest. In a recent class-action lawsuit, J.P. Morgan Chase ("JPM") was sued by former investors in a troubled investment vehicle called Sigma.[148] The plaintiffs in that lawsuit

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[144] Jesse Eisinger, Propublica, *In Fight Against Securities Fraud, S.E.C. Sends Wrong Signal*, N.Y. Times Dealbook, Oct. 26, 2011, http://dealbook.nytimes.com/2011/10/26/in-fight-against-securities-fraud-s-e-c-sends-wrong-signal/.
[145] *See* Tuch, *supra* note 142, at 32.
[146] *Id.*
[147] *See* David S. Hilzenrath, *Justice Department, SEC Investigations Often Rely on Companies' Internal Probes*, Washington Post, May 22, 2011, *available at* http://www.washingtonpost.com/business/economy/justice-department-sec-investigations-often-rely-on-companies-internal-probes/2011/04/26/AFO2HP9G_story.html ("As the U.S. government steps up investigations of companies suspected of paying bribes overseas, law enforcement officials are leaving much of the detective work to the very corporations under suspicion.").
[148] Louise Story, *JPMorgan Accused of Breaking Its Duty to Clients*, N.Y. Times, Apr. 10, 2011, http://www.nytimes.com/2011/04/11/business/economy/11bank.html.

alleged that JPM knew about Sigma's impending demise, yet failed to alert them of that fact. JPM made handsome profits from the collateral held by Sigma after that investment vehicle ultimately failed. This case seems to present a classic case of conflict of interest. However, JPM has argued in court that its information barriers actually **precluded** it from providing the plaintiffs with the disclosures necessary to protect their interests.[149] "The bank argues that by law, different units of the company that dealt with Sigma could not share information, because of so-called Chinese walls, which are meant to prevent the spread of nonpublic information within the firm."[150] If JPM is to be believed, information barriers actually make conflict mitigation more difficult, especially where conflicts arise from activities in different units within a banking conglomerate. Therefore, the Agencies should seriously question whether information barriers have any curative utility in conflicted transactions.

**<u>Question 213</u>. Is the proposed rule's definition of a high-risk asset effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should the proposed rule specify particular assets that are deemed high-risk per se? If so, what assets and why?**

The Proposed Rule is ineffective because it does not properly define the term "high-risk asset." The term is defined to include "an asset or group of related assets that would, if held by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail."[151] The NPR perplexingly avoids explicitly defining the term to include "illiquid assets." Illiquid assets certainly fit the bill as assets that substantially increase the likelihood of bank failure. For proof, the Agencies need look no further than the example of Lehman Brothers, which collapsed largely under the weight of its risky bets in illiquid markets.[152]

Credit derivatives should also be designated, pro forma, as "high risk assets." The role that these instruments played in the recent financial crisis has been well documented.[153] Essentially, *credit derivatives are insurance products free from the protections of insurance regulation*. As such, they pose a grave threat to the American economy (not to mention bank depositors), and should be covered by the Volcker Rule's restrictions. For similar reasons, synthetic securities that derive their value from other assets or liabilities should also be considered "high risk."

As discussed in detail in Question 30, repurchase agreements and securities lending transactions can contain in-built proprietary positions. The structured varieties of these transactions are

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[149] *Id.*
[150] *Id.*
[151] Proposed Rule § _.8(c)(1).
[152] *See* Abigail Field, *Lehman Report: The Business Decisions That Brought Lehman Down*, Daily Finance, Mar. 14, 2010. http://www.dailyfinance.com/2010/03/14/lehman-report-the-business-decisions-that-brought-lehman-down/.
[153] Jesse Eisinger, *The $58 Trillion Elephant in the Room*, Portfolio.com, Oct. 15. 2008. http://www.portfolio.com/views/columns/wall-street/2008/10/15/Credit-Derivatives-Role-in-Crash/.

especially dangerous, because they are typically connected with very heavy leveraging, all the while being misconstrued for capital adequacy purposes as mere "secured loans."

Although securities issued by certain government-sponsored enterprises (GSEs) are exempted by Section 619, the Agencies should require a banking entity seeking to trade such securities to first file a transaction-specific application with the Federal Reserve to get pre-clearance based on an assessment of the risks involved in that transaction. High-risk mortgage purchases and guarantees by GSEs helped fuel the recent housing bubble and financial crisis.[154] The GSEs played a pernicious role in the recent economic crisis, and securities issued by these entities should not be given the same preference that is afforded to U.S. Government Treasury bonds. In September 2008, the U.S. Treasury placed Fannie Mae and Freddie Mac into conservatorship. Any securities issued by these enterprises have "bailout" written all over them.

For similar reasons, the Agencies should require an interpretive determination by the Federal Reserve before a banking entity is allowed to trade in municipal bonds. Even large municipalities have teetered on the verge of default in the past.[155] For instance, New York City almost defaulted on its debts in 1975. The same was true for Cleveland in 1978. Orange County, California famously filed for bankruptcy in 1994. The risk of default is exacerbated in smaller municipalities with fewer resources available to them as recourse. Issuances by small municipalities are also more susceptible to outright fraud. "JPMorgan Chase & Co. (JPM)'s Charles LeCroy said the key to landing bond deals in Jefferson County, Alabama, was finding out whom to pay off."[156] The exemption at § _.6(a)(ii) conveys the impression that bonds issued by the United States Treasury are considered as safe as bonds issued by even the smallest, remotest political subdivisions of States. Such is simply not the case.

We further recommend that the Agencies focus their attention on traditionally "low risk" assets as well, for a number of reasons. For one, "low risk" exposures are subject to lower capital reserves, which magnifies the potential fallout from unexpected defaults. Moreover, ostensibly "low risk" exposures end up being so designated across all banks that utilize similar risk-weighting methodologies. Correlations in pricing methodologies across banks thereby amplify the consequences of default. Indeed, the Agencies should apply the greatest scrutiny to exposures that are designated as "low risk" by third parties, such as rating agencies, especially where those parties have financial incentives to issue unduly favorable ratings.

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[154] Dwight M. Jaffee, The Role of the GSEs and Housing Policy in the Financial Crisis (Feb. 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0227-Jaffee.pdf.

[155] Marilyn Cohen, *Municipal Bonds: Armageddon Or Opportunity?*, Forbes.com, Jan. 19, 2009, http://www.forbes.com/2009/01/17/municipal-bonds-bankruptcy-pf-in_mc_0119tmunibonds_inl.html.

[156] William Selway & Martin Z. Braun, *JPMorgan Proves Bond Deal Death in Jefferson County No Bar to New Business*, Bloomberg, Aug. 12, 2011, *available at* http://www.bloomberg.com/news/2011-08-12/jpmorgan-proves-bond-deal-death-in-jefferson-county-no-bar-to-new-business.html.

The recent European sovereign debt crisis took even seasoned market observers by surprise.[157] **The fact is that virtually all assets can be "high-risk,"** especially if held in high concentration. In light of this economic reality, the Agencies should deem all trades to be *prima facie* "high-risk," and only allow Section 619(d) exemptions on a case-by-case basis, pursuant to a separate application by the concerned bank. Such an interpretation may be unpopular in the banking community, but the Agencies should be motivated by an objective assessment of the myriad holdings that can bring a bank to failure, and not by partisan pressure from the banking lobby.

The Proposed Rule makes insufficient use of CEO certifications as an enforcement tool. At present, CEO verification is only required within the contexts of certain prime brokerage transactions and the Volcker Rule's programmatic compliance regime. For any banking entity that relies on any exclusion from the general Volcker prohibition (e.g., market-making, government securities, exempted funds, etc.), the Agencies should also require that the CEO specifically certify that the banking entity's activities do not result in a material exposure of the banking entity to high-risk assets or high-risk trading strategies, and further do not pose a threat to the financial stability of the banking entity or the United States. Although the limitations on high-risk activities are already embedded in the Rule, these provisions will actually benefit from real-world enforcement if CEOs are held personally accountable.

**Question 214. Is the proposed rule's definition of a high-risk trading strategy effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should the proposed rule specify particular trading strategies that are deemed high-risk per se? If so, what trading strategies and why?**

The Proposed Rule is ineffective because it does not properly define the term "high-risk trading strategy." This term is currently defined to include "a trading strategy that would, if engaged in by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail." The Agencies have failed to specify any trading strategies that are risky *per se*. Below, we describe several trading strategies that should fall within the definition.

Leverage Cap on Permitted Proprietary Trading

The Agencies should ban any proprietary trade that is permitted under a Section 619(d) exclusion if that trade is conducted through leverage that exceeds 3-to-1 debt-to-equity leverage. This also means that any "covered fund" must maintain a leverage ratio of 3-to-1 or less. We recognize that a 3-to-1 cap on leverage may be more restrictive that current banking standards in various contexts. Admittedly, the Market Risk Capital Rules, the upcoming implementation of Basel III, and various broker-dealer rules all impose less exacting leverage limitations on banks for what

[157] *See* Amalia Estenssoro, *European Sovereign Debt Remains Largely a European Problem*, The Regional Economist (Federal Reserve Bank of St. Louis), Oct. 2010.

are currently-routine banking transactions. Even so, the Section 619(d) exemptions are not meant to allow banks to carry on "business as usual," and so the "usual" leverage standards need not apply in this context.

The Agencies must remain cognizant of the fact that the Section 619(d) exemptions are only meant for the most staid, basic, "plain vanilla" proprietary trades. "[T]he intent of section 619 is to restore the purpose of the Glass-Steagall barrier" and the exemptions to the basic ban on proprietary trading are only meant for "low-risk, client-oriented financial services."[158] The imposition of a 3-to-1 leverage would comport with the legislative mandate to require that any permitted exemptions be "low-risk." In fact, *if the Agencies decline to implement this recommendation, we would challenge them to demonstrate how the absence of any explicit leverage requirement in their Proposed Rule satisfies the legislative mandate for "low-risk."*

The role that leverage played in the recent financial crisis is well understood. In April 2004, the SEC voted unanimously to permit the largest broker-dealers to increase their leverage limits up to 30-to-1 or higher.[159] That decision has been identified as a major cause of the recent "Great Recession."[160] Bear Stearns and Lehman Brothers are conspicuous for their presence on this list of the SEC's "favorite sons."

The SEC and the other Agencies have been presented with an opportunity to undo the damage of that April 2004 decision. The Volcker Rule's "high-risk trading" backstop is an opportunity for the Agencies to impose explicit leverage limits on banking entities conducting exempted proprietary trading. One commentator has even argued that the imposition of appropriate leverage ratios would obviate much of the Volcker Rule's complexity.[161] The imposition of a 3-to-1, or some other prudent leverage limit would provide the markets with definitional certainty on a significant aspect of the Volcker Rule, and would help safeguard the fiscal health of the global economy.

Ban on Rehypothecation

One particularly nefarious trading strategy that should be banned in connection with permitted proprietary trading is the practice of rehypothecation. Rehypothecation occurs when banks borrow from third parties using collateral that is made up of securities or other assets that have been posted as collateral by the bank's client in a separate transaction. This practice is

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[158] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).
[159] *See, e.g.*, Joseph E. Stiglitz. *Capitalist Fools*. Vanity Fair, Jan. 2009, *available at* http://www.forbes.com/2009/09/25/clinton-global-initiative-personal-finance-investing-ideas-bill-clinton.html.
[160] Alan S. Blinder. *Six Errors on the Path to the Financial Crisis*, N.Y. Times, Jan. 24. 2009, *available at* http://www.nytimes.com/2009/01/25/business/economy/25view.html.
[161] *See* William R. Hambrecht, Making the Volcker Rule Work for America: A Pragmatic Alternative to Exemptions 1 (Nov. 9. 2011), http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2011/11/Bill-Hambrecht-Volcker-Rule-Paper-11-9-11.pdf.

particularly dangerous because rehypothecations can occur in chains, such that the same collateral is reused multiple times in successive borrowings. The obvious problem is that the actual assets backing the borrowings never change, whereas the overall exposure is multiplied at each successive level. The amount of potential counterparty risk in these transactions is astonishing. For instance, the last creditor in a chain of five rehypothecations is reliant on the creditworthiness of six upstream entities. Worse still, the creditor may not be aware that the posted collateral has been churned in this fashion.

While there appear to be some limits on the practice of rehypothecation in the United States, American banks have found ways to evade these restrictions through regulatory arbitrage.[162] The United Kingdom does not effectively restrain the practice, and so American banks use foreign affiliates as conduits for rehypothecation. "Even without circumventing U.S. limits on rehypothecation, the off-balance sheet treatment means that the amount of leverage (gearing) and systemic risk created in the system by rehypothecation is staggering."[163] Moreover, there is speculation that this practice may have contributed to the loss of customer funds in the recent MF Global debacle.[164]

We are especially disconcerted by the fact that a significant amount of the "liquidity" that exists in the various markets may actually be little more than a House of Cards propped up by rehypothecations. The systemic risk of rehypothecations is not fully known because "financial stability assessments typically[] do not include pledged collateral, or the associated reuse of such assets."[165] Despite being little more than a hollow subterfuge, rehypothecations appear to be widespread:

> Engaging in hyper-hypothecation have been Goldman Sachs ($28.17 billion re-hypothecated in 2011), Canadian Imperial Bank of Commerce (re-pledged $72 billion in client assets), Royal Bank of Canada (re-pledged $53.8 billion of $126.7 billion available for re-pledging), Oppenheimer Holdings ($15.3 million), Credit Suisse (CHF 332 billion), Knight Capital Group ($1.17 billion), Interactive Brokers ($14.5 billion), Wells Fargo ($19.6 billion), JP Morgan ($546.2 billion) and Morgan Stanley ($410 billion).[166]

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[162] Christopher Elias, *MF Global and the Great Wall St Re-hypothecation Scandal*, Thomas Reuters News & Insight, Dec. 7, 2011. http://newsandinsight.thomsonreuters.com/Securities/Insight/2011/12_-_December/MF_Global_and_the_great_Wall_St_re-hypothecation_scandal/.
[163] *Id.*
[164] *Id.*
[165] Manmohan Singh. Velocity of Pledged Collateral: Analysis and Implications 18 (Nov. 2011) (IMF Working Paper), http://www.imf.org/external/pubs/ft/wp/2011/wp11256.pdf.
[166] Tyler Durden, *The Denials Begin: Interactive Brokers Is First To Claim It Has Not Engaged In Commingling Rehypothecation*, Zero Hedge, Dec. 11, 2011. http://www.zerohedge.com/news/denials-begin-interactive-brokers-first-claim-it-has-not-engaged-commingling-rehypothecation.

Defining "high-risk trading strategy" to explicitly include rehypothecation is but a necessary first step. The Agencies should give serious thought to also tightening up other relevant regulations to account for the risks posed by this practice.

Limits on Concentration

The Agencies should ban any proprietary trade that is permitted under a Section 619(d) exclusion if that trade would result in the banking entity owning over 50% of the market capitalization or total outstanding value of any covered financial position. Banking entities that hold inordinately large concentrations of covered financial positions face nondiversification risk with respect to those holdings. In many circumstances, unfavorable market movements can debilitate a bank if its holdings are not diversified. The risk attendant to such nondiversification is ultimately borne by depositors and taxpayers, to their detriment. For instance, in May 2008, the OCC closed ANB Financial, NA, an Arkansas bank with $2.2 billion in total assets.[167] That bank failed partly because of gross under-diversification: 85% of ANB's funding came from brokered deposits.

Additionally, a bank retaining a controlling position in the outstanding interests of a covered financial position has an incentive to "bail out" the institution issuing the covered financial position if that institution faces economic difficulty. This incentivation compounds the risk to depositors and taxpayers from the bank's over-concentrated holding.

It should be noted that banks would continue to be able to conduct permitted underwriting despite this limitation. Such underwriting could be conducted in stages or with the participation of other underwriters in a syndicate. Incidentally, this type of staggered underwriting would promote optimal price discovery for the underwritten security, as the markets would be allowed more time to properly determine equilibrium pricing.

Personal Trader Liability

None of the major investment banks currently operate as partnerships, but decades ago most did utilize that structure.[168] The largest banks now operate under the public company structure, which leads to a striking moral hazard in the manner in which these banks conduct trades. Since traders have no personal liability, there is little real downside to incurring monumental losses. Provided that no fraud occurs, the worst-case scenario for a trader who loses millions or billions of dollars of depositor-backed money is the loss of a job. Given that bank bonuses have continued unabated through the crisis, one might even imagine that such a trader would enjoy a lucrative bonus before heading off to a new job at a competing bank. The problem with this

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[167] James W. Fuchs & Timothy A. Bosch, *Why Are Banks Failing?*, Central Banker (Federal Reserve Bank of St. Louis), Fall 2009, *available at* http://www.stlouisfed.org/publications/cb/articles/?id=1667.

[168] Claire A. Hill & Richard W. Painter, *Another View: A Simpler Rein Than the Volcker Rule*, Oct. 28, 2011, *available at* http://dealbook.nytimes.com/2011/10/28/another-view-a-simpler-rein-than-the-volcker-rule/.

limited liability trading strategy is that it encourages speculation by traders, who face no real downside risk to playing with other people's money. The Agencies can ameliorate this situation by holding traders relying on a proprietary trading exemption to be personally liable for any losses. This requirement would be consistent with the legislative mandate that Section 619(d) permitted activities be safe and customer-oriented. Two law professors have proposed this very idea as an alternative to the arcane vicissitudes of the Proposed Rule.

> We cannot bring back the old investment banking partnerships, and most investment banks will continue to be public companies. We can, however, require the most highly paid executives in these firms to personally guarantee the debts of their firms in return for their high salaries and bonuses, or pay them with stock that is subject to a cash assessment if the firm gets into trouble and becomes insolvent.[169]

This personal liability does not need to be debilitating to an individual who mistakenly incurs losses in good faith. For instance, the Agencies can require that any trader relying on a Section 619(d) maintain something akin to a capital account that tracks gains or losses on traded positions. Any gains or losses from price movements would be itemized using the capital account, and any deficiencies in that account would be deducted from the trader's salary to the extent that the salary (including bonuses and expenses paid) is above $100,000. This way, traders would still enjoy financial "incentives" to work at prestigious banks, but would personally "feel the pinch" for their losses, instead of just outsourcing the pain to their customers, depositors or the American taxpayer, as is usually done.

This system will approximate the old partnership model of investment banks. In that model, bankers knew that their money was at stake so they took less risk. Unfortunately, the corporatization of these investment partnerships has led banks to concoct ever more complex instruments and other risky machinations in the pursuit of profit. The Agencies should utilize personal liability or a similar strategy to address trader moral hazard. The prohibition on high-risk trading strategies is but an after-thought in the Proposed Rule's current format, and the imposition of personal liability would make it robust.

Ban on High-Frequency Trading

The Proposed Rule elides regulating one of the most precarious trading strategies that exists today: high frequency trading ("HFT"). HFT has been recognized by international securities regulators as causative of the flash crash event of May 6, 2010.[170] HFT is primarily used for

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[169] *Id.*

[170] Huw Jones, *Ultra Fast Trading Needs Curbs - Global Regulators*, Jul. 7, 2011, *available at* http://uk.reuters.com/article/2011/07/07/regulation-trading-idUKN1E7661BX20110707.

proprietary trading.[171] Even if banking entities provide HFT as a client service, it has no legitimate place in a prudent, risk-averse banking entity's trading arsenal. In passing Section 619, Congress's purpose was "refocusing the bank on its credit extension function"[172] and away from financial trading machinations. By abdicating trading decisions to computer algorithms, HFT subjects markets to wild, unchecked swings in volatility.

> [T]here is the risk that rogue algorithms, i.e., algorithms that malfunction and operate in an unintended way, may trigger a chain reaction and, in turbulent market conditions, withdraw liquidity from the market or impair orderly trading. Such risk is magnified when the speed of trading takes place at fractions of a second.[173]

From a practical standpoint, regulators have a very limited ability to redress the risks borne of HFT simply because of the speed with which these transactions are completed. Thus, we recommend that the Agencies impose a resting period on any order placed by a banking entity relying on a 619(d) exemption. For instance, this resting period could forbid a banking entity from buying and subsequently selling a covered financial position within the span of 2 seconds. A resting period requirement would limit some of the wild volatility that the markets have seen in recent months, by reducing the risk of liquidity drought. A senior executive of the Bank of England has championed such a measure:

> While raising the average bid-ask spread, [a resting period requirement] might also lower [spread] variability at times of stress. Liquidity would on average be more expensive but also more resilient.[174]

A resting period has been considered by European regulators, and their American counterparts should do the same.

The banking lobby will predictably remonstrate with an expansive interpretation of "high-risk asset" and "high-risk trading strategies" would reduce liquidity in the market. In assessing these remonstrations, the Agencies are reminded to abide by the legislative intent behind the Volcker Rule, which reaffirms that "it is irrelevant whether or not a firm provides market liquidity: high-risk assets and high-risk trading strategies are never permitted."[175]

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[171] Technical Committee of The International Organization Of Securities Commissions (OICU-IOSCO). *CR02/11, Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency* 21 (July 2011) [hereinafter Technical Committee].
[172] 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley).
[173] Technical Committee. *supra* note 171, at 29.
[174] Andrew G. Haldane, Executive Director, Financial Stability. Bank of England. Address at International Economic Association Sixteenth World Congress, Beijing, China 18 (July 8, 2011), http://www.bankofengland.co.uk/publications/speeches/2011/speech509.pdf.
[175] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).

**<u>Question 216</u>. Does the proposed rule effectively address the circumstances under which an investment by a director or employee of a banking entity in a covered fund would be attributed to a banking entity? If not, why? What alternative might be more effective?**

The Proposed Rule does not effectively address when an investment by a banking entity employee should be attributed to a banking entity. Specifically, the Proposed Rule fails to set limitations on self-funded, personal ownership interests held by banking entity employees working as investment advisers.

In the NPR's current form, the only instance where a banking employee can take on an ownership interest is when that employee or director is acting as investment advisor to the covered fund.[176] Even if the ownership interest is based on a personal[177] ownership interest, any such interest should **also** be attributed to the banking entity. Failure to attribute personal ownership interest by an investment advisor working for the banking entity leaves room for improper incentives to bail out the covered fund should it reach dire straits. For example, a situation could arise where the investment adviser were a majority or significant owner in the covered fund that she were advising. This investment advisor may be tempted to use her influence to provide assistance to the covered fund should it begin to falter.

Further, if the director or employee is in a position at the bank such that she can possibly influence the bank's decision to fund, bail out, or take some other significant action toward the fund, the director/employee's ownership interest must be attributed to the bank. Under this proposed revision, most directors would have their ownership interests attributed to the bank.

Section _.12(b)(1) should be amended to include a new component:

(iii) *Personal Investments by Banking Employees acting as Investment Advisor.*

We are also very concerned with § _.11(g), due to its inclusion of "other services." This language is too vague, and should be removed. The alleged purpose of the employee investment exception is to ensure that investment advisors have "skin in the game." However, the inclusion of the vague phrase "other services" may have the unintended consequence of allowing unrelated banking entity employees—who are not advising the fund and thus do not need "skin in the game" to drum up outside client investment interest—to invest in the fund and thus pollute the intent of Subpart C's restrictions.

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[176] 12 U.S.C. § 1851(d)(1)(G)(vii).

[177] The Proposed Rule expressly states that the banking entity cannot extend credit for such an investment.

**<u>Question 217</u>. Does the proposed rule's definition of "covered fund" effectively implement the statute? What alternative definitions might be more effective in light of the language and purpose of the statute?**

While we support the current definition of "covered fund" as defined in §§ _.10(b)(1)(i)-(iv) of the Proposed Rule, we feel that in *addition* to this definition, there could be a second, additive definition that allows the Agencies to include *other* funds not covered by § _.10(b)(1)(i) in the definition of covered fund.

Specifically, we suggest that the definition of "covered fund" be extended such that issuers identified in § _.10(b)(1)(i)-(iv) as well as *any* of the following issuers would qualify for the definition of a "covered fund":

> *§ _.10(b)(1)(v): An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.), but for Rule 3a-1 or Rule 3a-6 of the Rules and Regulations promulgated under that Act, and*
>
> *§ _.10(b)(1)(vi): Any issuer that the Commission deems to be a covered fund, should the Commission deem that said issuer exhibit the characteristics of a fund that takes on proprietary trading activities;*

We feel it is important to add § _.10(b)(1)(v) because it is possible to operate a hedge fund or other fund intended to be covered without relying on the 3(c)(1) or 3(c)(7) exemptions. See Question 233 for other examples of regulatory guises often taken by funds that should be covered.

**<u>Question 218</u>. Is specific inclusion of commodity pools within the definition of "covered fund" effective and consistent with the language and purpose of the statute? Why or why not?**

Yes, the inclusion of commodity pools within the definition of "covered fund" is both effective and consistent with the statute. Commodity pools are hedge funds, and they are some of the largest according to annual rankings in publications like *Industrial Investor*. LTCM was once a large commodity pool and its catastrophic systemic effect became legendary. Commodity speculation has created problems for markets in the past. Enron[178] created vast problems for California energy consumers through their proprietary trading activities. The taxpayers of California are still dealing with the after-effects of Enron's energy speculation, which caused rolling blackouts that propagated severe financial problems for the state.

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[178] While Enron was not a commodity pool, its disintegration showed what harm commodity speculation can do.

It is unclear what motivation is behind the exemption for commodity pools. The Congressional Record and statute recognize that proprietary trading can be done by taking an interest in commodities.[179] While we recognize there is disagreement between the rule makers about whether spot market transactions are covered financial positions, futures and options trading are within the proposal's framework of recognized covered financial positions. Thus, commodity pools that transact in options or futures markets (we do not know of any that do not) must be included in the definition of a covered fund because it would be inconsistent to allow them to take on covered financial positions without being recognized as covered funds.

**Question 219. The proposed definition of "sponsor" focuses on "the ability to control the decision-making and operational functions of the fund." In the securitization context, is this an appropriate manner to determine the identity of the sponsor? If not, what factors should be used to determine the identity of the sponsor in the securitization context for purposes of the proposed rule and why? Is the definition of "sponsor" set forth in the SEC's Regulation AB an appropriate party to treat as sponsor for purposes of the proposed rule? Is additional guidance necessary with respect to how the proposed definition of "sponsor" should be applied to a securitization transaction?**

We support the definition of "sponsor" outlined in the SEC's Regulation AB.

**Question 220. Should the application of the proposed definition of "sponsor" mean that the servicer or investment manager in a securitization transaction would be considered the sponsor for purposes of the proposed rule?**

Yes, it should. These interactions constitute sponsorship and, if exempted, could enable evasion of the statute's intent.

**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 3(c)(7) of the Investment Company Act? If so, what characteristics should be considered and why? Would a definition focusing on an entity's characteristics rather than its form be consistent with the language and purpose of the statute?**

Yes, the definition of "covered fund" should focus on fund characteristics, but the definition should be additive. The statute states that the Agencies have the authority to expand the scope of what counts as a "covered fund." Section 13(h)(2) of the BHC Act identifies 3(c)(1) and 3(c)(7) funds "or such similar funds as the appropriate Federal banking Agencies. . . may. . . determine" as falling within the definition of covered fund, and based on this quoted statutory language we encourage the Agencies to adopt a qualitative definition of "covered fund." This interpretation would facilitate the effective policing of any fund that engages in proprietary trading activity. To

[179] *See* 156 Cong. Rec. S5895 (daily ed. July 15. 2010) (statement of Sen. Merkley).

ensure this result, the Agencies should modify the language of Volcker to include a catchall *qualitative* category of covered fund that would include any subsidiary entity that exhibits the characteristics of a fund that takes on proprietary trading activities. The bottom line is that if a fund can devote any portion of its activities to proprietary trading activity then it should be considered a covered fund. Moreover, **the definition should be additive,** such that it defines a covered fund as being 3(c)(1) or 3(c)(7) fund, **or** any fund that engages in proprietary trading beyond a *de minimus* level.

**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 for "hedge fund" and "private equity fund"? If so, which definitions and why?**

No, any vehicle that can be used for proprietary trading should be covered. We strongly encourage the Agencies to adopt a more *qualitative* definition of covered fund that includes any entity capable of trading covered financial positions.

**Question 223. Should the Agencies consider using the authority provided under section 13(d)(1)(J) of the BHC Act to exempt the acquisition or retention of an ownership interest in a covered fund with certain attributes or characteristics, including, for example: (i) A performance fee or allocation to an investment manager's equity account calculated by taking into account income and realized and unrealized gains; (ii) borrowing an amount in excess of one-half of its total capital commitments or has gross notional exposure in excess of twice its total capital commitments; (iii) sells securities or other assets short; (iv) has restricted or limited investor redemption rights; (v) invests in public and non-public companies through privately negotiated transactions resulting in private ownership of the business; (vi) acquires the unregistered equity or equity-like securities of such companies that are illiquid as there is no public market and third party valuations are not readily available; (vii) requires holding those investments long-term; (viii) has a limited duration of ten years or less; or (ix) returns on such investments are realized and the proceeds of the investments are distributed to investors before the anticipated expiration of the fund's duration? Which, if any, of these characteristics are appropriate to describe a hedge fund or private equity fund that should be considered a covered fund for purposes of this rule? Are there any other characteristics that would be more appropriate to describe a covered fund? If so, which characteristics and why?**

A new exemption based on these enumerated possibilities would amount to a functional evisceration of the Volcker rule.

**Question 224. Is specific inclusion of certain non-U.S. entities as a "covered fund" under § _.10(b)(1)(iii) of the proposed rule necessary, or would such entities already be considered to be a "covered fund" under § _.10(b)(1)(i) of the proposed rule? If so, why? Does the**

**proposed rule's language on non-U.S. entities correctly describe those non-U.S. entities, if any, that should be included in the definition of "covered fund"? Why or why not? What alternative language would be more effective? Should we define non-U.S. funds by reference to the following structural characteristics: whether they are limited in the number or type of investors; whether they operate without regard to statutory or regulatory requirements relating to the types of instruments in which they may invest or the degree of leverage they may incur? Why or why not?**

The inclusion of certain non-U.S. entities, as proposed, is necessary, well phrased, and thorough.

**Question 225. Are there any entities that are captured by the proposed rule's definition of "covered fund," the inclusion of which does not appear to be consistent with the language and purpose of the statute? If so, which entities and why?**

Every entity that can invest in covered financial positions should be covered.

**Question 226. Are there any entities that are not captured by the proposed rule's definition of "covered fund," the exclusion of which does not appear to be consistent with the language and purpose of the statute?**

For further discussion of this issue, please see Question 233.

**Question 227. Do the proposed rule's definitions of "covered fund" and/or "ownership interest" pose unique concerns or challenges to issuers of asset-backed securities and/or securitization vehicles? If so, why? Do certain types of securitization vehicles (trusts, LLCs, etc.) typically issue asset-backed securities which would be included in the proposed definition of ownership interest? What would be the impact of the application of the proposed rules to these securitization vehicles? Are certain asset classes (collateralized debt obligations, future flows, corporate debt repackages, etc.) more likely to be impacted by the proposed definition of "covered fund" because the issuer cannot rely on an exemption other than 3(c)(1) or 3(c)(7) of the Investment Company Act?**

Securitization vehicles do not require a more explicit carve-out than what is already exempted under § _.13(d). For further discussion, please see Question 296.

**Question 230. Since certain existing asset-backed securities may have a term that exceeds the conformance or extended transition periods provided for under section 13(c) of the BHC Act, should the Agencies consider using the authority contained in section 13(d)(1)(J) of that Act to exclude those existing asset-backed securities from the proposed definition of "ownership interest" and/or should the rule permit a banking entity to acquire or retain an ownership interest in existing asset-backed issuers?**

No, as asset-backed securities already enjoy a significant exemption in § _.13(d).

**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?**

Yes. This concern can be addressed by interpreting § _.13(d) only to create an exemption for a bank's equity interests (i.e., controlling **and** residual interest) in a securitization vehicle that only securitizes "loans" as that term is understood under securities law. We support the current approach to limiting the scope of asset-backed security issuers as outlined in § _.13(d). Modifying the NPR to grant a blanket exemption for any entity issuing asset-backed securities is an invitation for evasion.

The restrictions outlined in § _.13(d) should **not** be removed. If they are, a banking entity could structure a hedge fund's or private equity fund's products as asset-backed securities, and completely subvert the intent of the Rule, all with a legal cover provided by the Agencies.

That said, we do feel that the particular allowance in § _.13(d)(2) for "contractual rights or assets directly arising from those loans supporting the asset-backed securities" is vague and warrants further clarification on what is, and what is **not**, included in this allowance. We have outlined our specific suggestions for how to amend § _.13(d)(2) in Question 296.

**If this approach is taken, how should the proposal address this concern?**

We do **not** support a blanket exemption of any entity issuing asset-backed securities.

**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?**

Yes, structural similarities exist and are of concern, which is why the Agencies should not broadly exclude any entity that issues asset-backed securities from the definition of covered fund.

**Question 233. Should entities that rely on a separate exclusion from the definition of investment company other than sections 3(c)(1) or 3(c)(7) of the Investment Company Act be included in the definition of "covered fund"?**

Yes.

**Why or why not?**

The Agencies should change § _.10(b)(1)(i) so that an issuer that would be an investment company but for sections 3(c)(1), 3(c)(2), or 3(c)(7) of the Investment Company Act, Rule 3a-1 or Rule 3a-6 of the Rules and Regulations promulgated under that Act, or the SEC's authority to issue exemptive orders. Covered funds can take the form of broker-dealers under section 3(c)(2) of the Investment Company Act and maintain a majority of assets in government securities, avail of the Rule 3a-1 or Rule 3a-6 exemption, or avail of an explicit exemptive order, and in doing so carry out proprietary trading through that fund free of the Volcker Rule's limitations.

Rule 3a-1 creates a *prime facie* exclusion from the Investment Company Act if 55% or more of the fund's value is stored in government securities and other non-investment securities. A fund can still avail of the 3a-1 exclusion while devoting up to 45% of its assets to explicit proprietary trading. Unless the 3a-1 exclusion is brought within the ambit of the Volcker Rule, a banking entity could purchase a fund availing of this exclusion, and conduct extensive proprietary trading (up to 45% of the fund) free of the Volcker Rule's prohibitions.

We recognize that a 3(c)(2) broker dealer is required to be "primarily engaged" in customer-focused activities.[180] However, the current interpretation of "primarily engaged" would create an enormous loophole for banking entities to skirt the covered fund restrictions. A fund can still avail of the 3(c)(2) exemption while devoting up to 45% of its assets to explicit proprietary trading.[181] Unless 3(c)(2) broker-dealer funds are brought within the ambit of the Volcker Rule, a banking entity could purchase such a fund as a subsidiary, and conduct extensive proprietary trading (up to 45% of the fund) free of the Volcker Rule's prohibitions.

Foreign banks exempted under 3a-6 are required to be engaged "substantially" in commercial banking activity, but members of the securities bar have been comfortable opining that a 20% activity level is sufficient to qualify as "substantial."[182] Unless 3a-6 is brought within the scope of the Volcker Rule, a banking entity could conduct proprietary trading activities through the acquisition of a foreign bank subsidiary that is engaging 79.99% in investing, reinvesting, or trading in securities. The NPR recognizes that certain funds falling within the 3(c)(1) or 3(c)(7) exemptions are not generally used to engage in investment or trading. Similarly, one might argue that it would be unduly burdensome to impose the Volcker Rule's record keeping requirements on such funds. However, the fact is that those funds could always be used for

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[180] *See generally, U.S. v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 713-19 (1975).
[181] *See Federated Capital Mgmt. Assoc.*, SEC No-Action Letter (Aug. 1, 1975).
[182] Seward & Kissel, SEC No-Action Letter (Oct. 15, 2005), *available at* http://www.sec.gov/divisions/investment/noaction/seward101205.htm.

proprietary trading at a later date, and including them as "covered funds" and requiring them to report required information is wholly appropriate. The Agencies have the authority to expand the scope of "covered fund" under 13(h)(2) beyond 3(c)(1) and 3(c)(7) funds. In fact, the FSOC has specifically recommended that the Agencies utilize this authority to broaden the scope of "covered fund" beyond a definition tied to 3(c)(1) and 3(c)(7):

> [T]he Council recommends that Agencies consider using their authority to expand the definition by rule to funds that do not rely on the section 3(c)(1) and 3(c)(7) exclusions, but that engage in the activities or have the characteristics of a traditional private equity fund or hedge fund.[183]

We have suggested an extension to the definition of "covered fund" in *Annexure B*.

**Question 234. Do the proposed rule's definitions of "ownership interest" and "carried interest" effectively implement the statute?**

We do **not** believe that the NPR's exclusion of "carried interest" from the definition of "ownership interest" effectively implements the statute. The exclusion of carried interest is **not** mentioned in or provided for by the Volcker statute. Instead, the exemption of carried interest from the definition of ownership interest seems to have been added as a result of lobbying by the financial industry. In their comment letter to FSOC prior to the FSOC Study, SIFMA recommended that carried interest be treated as incentive compensation, and not as an ownership interest.[184] We do not believe that the requests of SIFMA should trump the statute. Thus, since carried interest is not at all mentioned in the statute, and since there is no indication of any intent to create special allowances for carried interest present in the Congressional Record, we ask the Agencies to respect the statute and Congressional intent and **include carried interest as an ownership interest.** A reviewing court shall hold unlawful and set aside agency action, findings, and conclusions found to be in excess of statutory jurisdiction, authority, or limitations, or short of statutory right.[185]

Additionally, the NPR at § _.10(b)(3)(i) limits a bank's ability to take on an option (i.e., a positive only position) in a covered fund, but fails to recognize that an option is **highly similar** to carried interest. Thus, if options on a covered fund are considered an ownership interest, carried interest should also be considered an ownership interest.

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[183] FSOC Study, *supra* note 54, at 62.

[184] SIFMA, *Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds* 20 (Nov. 5, 2010), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=22125 ("The FSOC should recommend that the Regulatory Agencies treat carried interest as incentive compensation, and not an ownership interest, for purposes of the 3% limit on total ownership interests in a fund under the Volcker Rule") (emphasis omitted).

[185] 5 U.S.C. § 706 (2011).

Further, § _.10(b)(3)(ii)(A)(1) requires that, in order for carried interest to be considered separate from ownership interest, the banking entity "may be obligated under the terms of such interest to return profits previously received." This allowance for claw backs of carried interest means that such an interest has downside risk. A major argument to allow carried interest has been that there is no downside risk. However, this is not true because there can be claw backs.

We do, however, support the restrictions in §§ _.10(b)(3)(ii)(A)(2), (3) and (4). Section _.10(b)(3)(ii)(A)(2) will prevent evasion of the de minimis ownership interest limits by requiring that any carried interest paid be immediately divested. Section _.10(b)(3)(ii)(A)(3) will prevent "buying out" a fund or, effectively, bribing it to provide carried interest to the banking entity. Also, § _.10(b)(3)(ii)(A)(4) will prevent the case where a banking entity may wish to structure its carried interest as a swap or other derivative, and sell it to another party. Derivatives on carried interest have been made in the past, as described in the paper "Using Derivatives to 'Transfer' Carried Interests" by Kirkland & Ellis,[186] and § _.10(b)(3)(ii)(A)(4) is a good preventative measure against the securitization and sale of carried interest.

Should the Agencies fail to incorporate our suggestion that carried interest be treated as an ownership interest, we feel that it is imperative to effective enforcement of the Volcker Rule that §§ _.10(b)(3)(ii)(A)(2), (3) and (4) be retained in the Final Rule.

**What alternative definitions might be more appropriate in light of the language and purpose of the statute?**

We urge the Agencies to include in the Final Rule a new definition for § _.10(b)(3)(ii) that will redefine ownership interest to **include** carried interest, as described in *Annexure B*.

**Are there other types of instruments that should be included or excluded from the definition of "ownership interest"?**

The FSOC Study recommended that the Agencies consider **synthetic ownership exposure** in their implementation, so as not to allow "banking entities to retain a synthetic or other interest in a fund, effectively exposing the banking entity to the risks and benefits of ownership otherwise prohibited under the Volcker Rule."[187]

In order to prevent banks from obtaining synthetic exposure to covered funds through counterparties not covered under Volcker, we suggest the following revision to the definition of ownership interest:

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[186] David Handler & Angelo Tiesi, Kirkland & Ellis LLP. *Using Derivatives to "Transfer" Carried Interests in Private Equity, LBO and Venture Capital Fund*, Venture Capital Review, Spring 2006. *available at* http://www.kirkland.com/siteFiles/kirkexp/publications/2291/Document1/VCR_Issue17_Kirkland&Ellis.pdf.

[187] FSOC Study, *supra* note 54, at 66.

> (i) Ownership interest means any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, or any derivative of such interest, *or any interest that derives its value from the performance or value of the covered fund.*[188]

**Does the proposed definition of ownership interest capture most interests that are typically viewed as ownership interests? Is the proposed rule's exemption of carried interest from the definition of ownership interest with respect to a covered fund appropriate? Does the exemption adequately address existing compensation arrangements and the way in which a banking entity becomes entitled to carried interest?**

The NPR's exemption of carried interest from the definition of ownership interest is **not** appropriate. Carried interest is not appropriate as it is similar to a fee that tracks gains on price movements, which Volcker prohibits. Investment advisers should earn money through flat fees for customer service, regardless of outcome. Fund investors' requests that the investment adviser have "skin in the game" can be addressed through the banking entity's de minimis 3% interest in the fund. Otherwise, the bank's depositors unwittingly end up having their "skin in the game."

Carried interest is also inappropriate because, facing limited or no downside exposure, investment advisers have incentives to take extremely risky bets that could debilitate a fund and require a bailout by the bank. Investment advisers also have a conflict of interest with their clients (fund investors), who **do** have a downside risk. Finally, investment advisers have incentives to influence the bank to bail out a failing fund in order to ensure that their cash cow (carried interest and deferred compensation) is not affected.

A bank bailout of a covered fund can be easily done despite the Volcker Rule. All the bank has to do is close a failing fund, and return money to the investors. The same investors can then buy into a new fund that is basically a clone of the old one. The bank can then fully "seed" the clone fund at much higher rates of investment than the 3% de minimis limit. Given the gargantuan size of most major banks, the 3% aggregate limit would not be a real impediment to this stratagem.

Carried interest also creates incentives for any banking entity employee acting as investment advisor to encourage the banking entity to acquire as large an ownership interest as possible through a risk-mitigating "hedge" (as allowed by § _.13(b)(1)(i)(B) of the NPR). This is because the more assets under management (AUM) the fund has, the larger the potential carried interest for the investment advisor employee.

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[188] Proposed Rule § _.10(b)(3)(i).

The NPR allows banking entities to "hedge" deferred compensation as long as it is "in the same amount of ownership interest in the covered fund that . . . is directly connected to [a bank's] compensation arrangement with an employee that directly provides investment advisory services to the covered fund."[189] As we describe in our response to Question 281, the NPR makes no qualifications of what "in the same amount" means for a compensation arrangement. Under the NPR as written, a banking entity could obtain or retain a near unlimited ownership interest using the exemption provided in § _.13(b)(1)(i)(B).

This leads to a potential conflict of incentives. The investment advisor employee will want the fund's assets under management (AUM) to be as large as possible. The larger the AUM, the more potential money the investment advisor can make via carried interest. The investment advisor employee has an incentive to inflate predications for the profit that she will earn the fund that year. This would compel the banking entity to take on as large of a "risk-mitigating" ownership interest as possible, because that would increase AUM and thus increase the size of the investment advisor's carried interest. Thus, any investment advisor who receives carried interest has an incentive to compel the banking entity to subvert the ownership limits as much as possible.

**Is it consistent with the current tax treatment of these arrangements?**

The exemption for carried interest **is not consistent with tax treatment** of carried interest. Carried interest is considered an ownership interest for the purposes of the tax code. However in Volcker, carried interest is **not** considered to be an ownership interest.[190] This is completely inconsistent with the tax treatment of the arrangements.

One of the major arguments in favor of taxing carried interest at a capital gains rate, as is the current practice, is that carried interest is an ownership interest. As William Dantzler, a partner at law firm White & Case LLP and head of its global tax practice, states in an op-ed piece on Bloomberg:

> **A carried interest is an ownership interest** in a partnership that entitles the partner to a percentage of the profits but doesn't obligate the partner to provide any capital.[191]

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[189] Proposed Rule § _.13(b)(2)(ii)(B).
[190] *See* William Dantzler, *If Carried Interest Irks You, You Do not Get It*, Bloomberg, Jan. 29 2012, *available at* http://www.bloomberg.com/news/2012-01-30/if-carried-interest-irks-you-don-t-get-it-commentary-by-william-dantzler.html (emphasis added).
[191] *Id.*

If the argument that upholds the ability to tax carried interest at a capital gains rate is that carried interest is an ownership interest, then it is insulting that the NPR would seek to deviate from this to argue the opposite. It seems that carried interest **is** an ownership interest when it benefits the most well-paid members of the financial community, and it is also **not** an ownership interest when it benefits the most well-paid members of the financial community. *The bankers would like to have their cake and eat it too.*

William Dantzler is hardly the first to make the argument that carried interest is an ownership interest. The Private Equity Growth Capital Council points out that carried interest is like a capital asset:

> Under current law, investments made by private equity funds are treated as capital assets, and the general partner's carried interest share of the net gains realized by the funds on disposition of those assets is taxed on a "pass-through" basis as capital gain.[192]

It is illogical that carried interest be treated as a capital asset for the purposes of taxation, but **not** as a capital asset for the purposes of the Volcker Rule.

Carried interest should not provide loopholes to banking entities and to covered funds in both the realm of taxation and the realm of regulation. Thus, for this and all of the reasons we have outlined above, we strongly suggest that the Agencies do **not** exclude carried interest from the definition of ownership interest.

**Question 235. In the context of asset-backed securities, the distinction between debt and equity may be complicated (e.g., trust certificates issued in a residential mortgage backed security transaction) and the legal, accounting and tax treatment may differ for the same instrument. Is guidance necessary with respect to the application of the definition of ownership interest for asset-backed securitization transactions?**

In order for the Proposed Rule to be consistent with Section 941(b) of the Dodd-Frank Act, which specifically states that the securitizer must retain "not less than 5 percent of the credit risk for any asset," ownership interest should be defined to include all assets that Section 941(b) specifically requires a banking entity to retain.

We further suggest that the Section 619(d) exemption only be applied to what is specifically required of a banking entity by Section 941, with one modification. Instead of "not less than 5 percent of the credit risk" as demanded by Section 941(b), the exposure allowed under the Section 619(d) exemption should be "exactly 5 percent of the credit risk."

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[192] Private Equity Growth Capital Council. Private Equity and the Treatment of Carried Interest: An Overview (May 4. 2007), http://www.pegcc.org/private-equity-and-the-treatment-of-carried-interest-an-overview/.

The 5% should be calculated according to a "horizontal" first-loss position, which is defined in the Proposed Rule for Dodd-Frank § 941 to be "whereby the sponsor or other entity retains a subordinate interest in the issuing entity that bears losses on the assets before any other classes of interests."[193]

**Question 236. In many securitization transactions, the residual interest represents the "equity" in the transaction. As this often constitutes the portion of the securitization transaction with the most risk, because it may absorb any losses experienced by the underlying assets before any other interests issued by the securitization vehicle, should the Agencies instead use their authority under section 13(d)(1)(J) of the BHC Act to exempt the buying and selling of any ownership interest in a securitization vehicle that is a covered fund other than the residual interest?**

Residual interest should **not** be removed from the definition of "ownership interest" in favor of a blanket exemption under Section 13(d)(1)(J). The reasons are twofold. First, preventing a banking entity from owning residual interest does **not** "promote the safety and soundness" of the United States financial system. When a banking entity takes on residual interest, it behooves the bank to structure deals well with solid loans, as it not only has skin in the game, its residual interest is the last to be paid. As stated in the Federal Reserve Bank of San Francisco's Economic Letter 2010-31: "retention of even modest loss exposure by originators reduces moral hazard and is associated with significantly lower loss rates on these securities. . . loss rates for affiliated deals average less than half the rates for mixed or unaffiliated deals."[194]

Second, Section 941(b) of Dodd-Frank specifically states that the securitizer must retain "not less than 5 percent of the credit risk for any asset." Thus, excluding the residual interest from the exemption would be in contradiction to the requirements of Dodd-Frank Section 941, which specifically allow for the "skin in the game" requirements to be met via a residual interest.

For further discussion, please see Question 235.

**Question 237. For purposes of limiting either an exclusion for issuers of asset-backed securities from the proposed definition of "covered fund" and/or an exclusion of asset-backed securities from the proposed definition of "ownership interest," what definition of asset-backed security most effectively implements the language of section 13 of the BHC Act? Section 3(a)(77) of the Exchange Act and the SEC's Regulation AB provide two possible definitions. Is either of these definitions sufficient, and if so why? If one of the**

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[193] Credit Risk Retention. 76 Fed. Reg. 24,090, 24,100 (proposed Apr. 29. 2011), *available at* http://www.sec.gov/rules/proposed/2011/34-64148.pdf.

[194] Christopher M. James. Mortgage-Backed Securities: How Important Is "Skin in the Game"? (Dec. 28. 2010), http://nationalmortgageprofessional.com/blog/mortgage-backed-securities-how-important-"skin-game".

**definitions is too narrow, what additional entities/securities should be included and why? If one of the definitions is too broad, what entities/securities should be excluded and why? Would some other definition of asset-backed security be more consistent with the language and purpose of section 13 of the BHC Act?**

In order to properly define the scope of the statutory rule of construction for securitizations, we propose that the Agencies adopt the following three-part definition of "ownership interest" in an exempted asset-backed security:

A. Any "ownership interest" by a banking entity in a SPV should fit the definition of "asset-backed security" in Regulation AB.

This definition would require that the ABS be registered under the 1934 Securities Exchange Act, and would also require that the ABS not be a synthetic ABS, as synthetics are explicitly excluded from Regulation AB's ambit:

> [S]o-called 'synthetic' securitizations are not included in Regulation AB's basic definition of ABS for purposes of determining whether the security qualifies for the particularized registration, disclosure and reporting regime under the Securities Act and Exchange Act we are adopting today.[195]

Because the Proposed Rule explicitly allows banking entities to sponsor or acquire ownership interests in covered funds that are ABS issuers[196] we strongly suggest that the definition from Regulation AB be used to define an ABS.

Banking entities should not be allowed to acquire interests in covered funds that issue the very products responsible for the meltdown in 2008, as such an allowance would pose a threat to the safety of the financial system. Thus, we recommend Regulation AB as the definitional source for "asset backed security" under the Volcker Rule because the Reg. AB definition excludes synthetic securitizations. This definition would protect the stability of the banking and financial markets by preventing banking entities from owning covered funds that participate in synthetic securitizations. Banking entities should not be allowed to acquire interests in covered funds that issue the very products that helped cause the meltdown in 2008.

B. The Agencies should further require that any ownership interest in an SPV (issuer of an asset-backed security) be in equity only, as defined below.

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[195] Asset-Backed Securities, Exchange Act Release Nos. 33-8518; 34-509405 (Mar. 8. 2005), *available at* http://www.sec.gov/rules/final/33-8518.htm.
[196] *See* Proposed Rule §§ _.13(d), _.14(a)(2)(v).

As a preliminary matter, the Agencies should apply a three-factor economic test in order to determine whether a banking entity has an "ownership interest" in a covered fund. Meeting **any** of the following three factors should be sufficient to count as indicative of an "ownership interest" generally:

- The banking entity has control over the fund
- The banking entity has residual interest in the fund, OR
- The banking entity has access to distributions from the fund's excess cash flow.

Conversely, in order for an ownership interest in an ABS issuer to qualify for the exemption provided by § _.13(d) and § _.14(a)(2)(v), we recommend that **all three** of the above factors must be met. This interpretation would ensure that an exemption is provided only for bona fide loan securitizations in which the banking entity is actively involved, consistent with the Congressional rule of construction.[197] Otherwise, an exemption for passive utilization of securitization vehicles would be a conduit for proprietary trading.

C. The Agencies should further require that any ownership interest in an SPV be capped at 5% of the residual, first-loss position in the SPV. This would allow banking entities to meet the requirements of Dodd-Frank § 941.

If the above proposal to revamp the definition of "ownership interest" is not acceptable to the Agencies, then we implore you at the very least to remove § _.13(d)(2) and § _.14(a)(2)(v)(B), which allows for "contractual rights or assets directly arising from those loans supporting the asset-backed securities." Moreover, if § _.13(d)(2) and § _.14(a)(2)(v)(B) are not removed, they must at a minimum be made more explicit, making it clear that credit default swaps, total return swaps and any form of repurchase agreement are specifically excluded from the exemption for loan securitizations.

**Question 238. Are there special concerns raised by not including as an ownership interest the residual interests in a securitization vehicle? Should the Agencies instead exempt the buying and selling of any ownership interest in a securitization vehicle that is a covered fund other than the residual interest?**

No. For further discussion, please see Questions 236 and 237.

**Question 239. Should the legal form of a beneficial interest be a determining factor for deciding whether a beneficial interest is an "ownership interest"? For example, should**

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[197] The Rule of Construction uses the active verbs "sell" and "securitize" in defining the bank's role. 12 U.S.C. § 1851(g)(2). Similarly, the Congressional Record refers to the bank's role "in the process of securitizing," which further reinforces the notion that banks must take an active role in a loan securitization for it to be exempted. *See* 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

**pass-through trust certificates issued as part of a securitization transaction be excluded from the definition of "ownership interest"? Should the definition of ownership interest explicitly include debt instruments with equity features (e.g., voting rights, profit participations, etc.)?**

No. For further discussion, please see Questions 236 and 237.

**Question 240. How should the proposed rule address those instances in which both debt and equity interests are issued, and the debt interests receive all of the economic benefits and all of the control rights? Should the debt interests (other than the residual interest) be counted as ownership interests even though they are not legally ownership and do not receive any profit participation? Should the equity interests be counted as ownership interests even though the holder does not receive economic benefits or have any control rights? Should the residual interest be considered the only "ownership interest" for purposes of the proposed rule? Should mezzanine interests that lack both control rights and profit participation be considered an ownership interest? If the mezzanine interests obtain control rights (because more senior classes have been repaid), should they become "ownership interests" at that time for purposes of the proposed rule? If both debt and equity interests are counted as ownership interests, how should percentages of ownership interests be calculated when the units of measurement do not match (e.g., a single trust certificate, a single residual certificate with no face value and multiple classes of currency-denominated notes)?**

Section _.13(d) already creates certain exemptions for securitizations. As to whether any *non-exempted* ABS security or other interest in a covered fund qualifies as an "ownership interest," the Agencies should apply a three-factor economic realities test under which any of the following factors will result in an "ownership interest" in a covered fund:

- The banking entity has control over the fund
- The banking entity has residual interest in the fund, OR
- The banking entity has access to distributions from the fund's excess cash flow.

Meeting **any** of the above three factors should be sufficient to count as indicative of an "ownership interest."

Conversely, in order for an ownership interest in a ABS issuer to qualify for an exemption provided by §§ _.13(d) and _.14(a)(2)(v), **all three** of the above factors should be met in order to qualify for the exemption.

For further discussion, please see Question 237.

**<u>Question 241</u>. Does the proposed rule's definition of "prime brokerage transaction" effectively implement the statute? What other types of transactions or services, if any, should be included in the definition? Should any types of transactions or services be excluded from the definition?**

The Congressional Record shows that the intention behind the allowances for prime brokerage in the statute were meant to be applied to **third-party funds only**:

> Subsection (f), paragraph (3) permits the Board to allow a very limited exception to paragraph (1) for the provision of certain limited services under the rubric of "prime brokerage" between the banking entity and a third- party-advised fund in which the fund managed, sponsored, or advised by the banking entity has taken an ownership interest.[198]

To be clear, this means that while J.P. Morgan may sponsor or advise Fund X, J.P. Morgan may **not** provide prime brokerage services to Fund X. However, should Fund X itself be invested in a different fund, Fund Y, J.P. Morgan **may** provide prime brokerage services to Fund Y, provided that J.P. Morgan does not also sponsor or advise Fund Y. The language of the Proposed Rule does not explicitly implement this Congressional intent, and thus must be modified to reflect that the prime brokerage allowance was only meant for third-party funds. While administrative agencies are granted a measure of deference, a reviewing court "will not defer to an agency's interpretation that contravenes Congress' unambiguously expressed intent."[199]

In order to amend this breach between congressional intent and the NPR, the Final Rule should amend § _.16(a)(2)(ii) to include the phrase "third party":

> (ii) Enter into any prime brokerage transaction with any *third party* covered fund in which a covered fund managed, sponsored, or advised by such covered banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest, if:

In addition, neither the Congressional Record nor the statute states that the exception for prime brokerage must include securities lending or borrowing. Thus, securities lending and borrowing should be removed from the definition of prime brokerage transaction.

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[198] 156 Cong. Rec. 5898 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("Subsection (f). paragraph (3) permits the Board to allow a very limited exception to paragraph (1) for the provision of certain limited services under the rubric of 'prime brokerage' between the banking entity and a third- party-advised fund in which the fund managed, sponsored, or advised by the banking entity has taken an ownership interest.").

[199] *Apker*, 455 F.3d at 80.

Marshall Huebner of Davis Polk & Wardwell, a law firm that has represented the Federal Reserve Bank of New York, stated that securities lending at AIG combined with the Arbitrage CDS holdings of AIG Financial Products led to a "double death spiral."[200]

Another risk inherent in securities lending is evident when we look at the Lehman Brothers Bankruptcy. As stated by The Practical Law Company in their April 2010 report "Trends in Prime Brokerage":

> When Lehman Brothers filed for bankruptcy, many funds were taken by surprise by the fact that the vast majority of their assets had been rehypothecated, and that they were therefore in the position of unsecured creditors in the UK insolvency proceedings concerning the value of those assets.[201]

One of the main causes of this subordination of interest was the standard securities-lending agreement that Lehman's Prime Brokerage group had at the time:

> The [securities-lending agreements] allowed the prime broker to transfer client assets between its various affiliates without the fund's express consent. As a result, all or most of the client assets were transferred to and held by LBIE [Lehman Brothers International (Europe)].[202]

Because LBIE were operating under UK law, this allowed for unlimited rehypothecation of the clients assets.

The Congressional Oversight Committee reported in June 2010 that collateral from securities lending was put into risky, profit-seeking investments:

> Rather than investing the cash collateral from borrowers in low-risk short-term securities in order to generate a modest yield, AIG invested in more speculative securities tied to the RMBS market. Consequently, these investments posed a duration mismatch (securities lending counterparties could demand a return of their collateral with very little notice) that was exacerbated by valuation losses and illiquidity in the mortgage markets that impaired AIG's ability to return cash to its securities lending counterparties.[203]

Given all the risks we have outlined, we ask that the Agencies strike "securities borrowing or lending services" from the definition of prime brokerage in the Final Rule.

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[200] Congressional Oversight Panel. *The Final Report*, *supra* note 29. at 131 n.398.
[201] Alarna Carlsson-Sweeny, *Trends in Prime Brokerage*, Practical Law The Journal. Apr. 2010, at 61.
[202] *Id.*
[203] Congressional Oversight Panel. *June Oversight Report*, *supra* note 28. at 7, 271-72.

We further ask that the Agencies strike "financing" from the definition of prime brokerage transaction as outlined in § _.10(b)(4). The statute very clearly laid out the fact that Sections 23A and 23B of the Federal Reserve Act would be used for the purpose of prohibiting "covered transactions" between a banking entity and a covered fund. One of the covered transactions described in 23A is "a loan or extension of credit."[204] We feel that including "financing" in the definition of a prime brokerage transaction violates the very explicit wording of the BHC Act Section 13(f)(1).

**Would an alternative definition be more effective, and if so, why?**

As we outline in *Annexure B*, the Agencies should redefine prime brokerage transaction to remove "financing" and "securities borrowing or lending services" from the definition:

> (4) Prime brokerage transaction means one or more products or services provided by a covered banking entity to a covered fund, such as custody, clearance, ~~securities borrowing or lending services,~~ trade execution, or ~~financing,~~ data, operational, and portfolio management support.

If the Agencies do not remove "financing" from the definition of prime brokerage transactions, then repurchase and reverse repurchase agreements should be explicitly excluded from the definition of "financing." The dangers inherent in allowing repos are discussed at length in our answers to Questions 30, 31 and 34.

Further, there is insolvency risk for investors of a covered fund due to the common practice of banking entity prime brokers demanding:

> the right to rehypothecate all assets although some jurisdictions (including the U.S.) impose limits. Rehypothecation exacerbates prime broker insolvency risk by increasing the likelihood that the prime broker will have insufficient assets to satisfy customers' claims. Hedge funds additionally face the risk of trades not being properly executed or credited immediately preceding and during an insolvency.[205]

While under the CFTC's Proposed Rule "Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy" implementing Dodd-Frank Section 724(c), counterparties now have the right to

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[204] 12 U.S.C. § 371c(b)(7)(a) (2010).

[205] Noah Melnick, Gary Barnett, Stephen Culhane, Stanford Renas & Don Macbean, Linklaters, *Prime Broker Insolvency Risk: After the Fall: What Next?*, The Hedge Fund Journal, Nov. 2008, *available at* http://www.thehedgefundjournal.com/magazine/200811/commentary/prime-broker-insolvency-risk.php.

"require segregation of the funds or other property that it supplies to margin, guarantee, or secure its obligations,"[206] which would largely prevent rehypothecation of the fund's assets, we feel it would be far more prudent to restrict rehypothecation of covered fund assets outright in this context.

Thus, if the Agencies will not remove "financing" or "securities borrowing or lending services" from the definition of permitted prime brokerage transactions, they should ban the rehypothecation of assets, regardless of whether the assets are held in the U.S. or in a foreign entity, as long as ownership interests in such covered funds are offered for sale or sold to a resident of the United States.

**Question 242. Do the proposed rule's definitions of "sponsor" and "trustee" effectively implement the statute? Is the exclusion of "directed trustee" from the definition of "trustee" appropriate?**

The definition of sponsor expressly includes, in § _.10(b)(5)(iii) the following language: "To share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name."

However, a banking entity is allowed to act as "sponsor" to:

- Small Business Investment Companies ("SBICs"): § _.13(a)(1)
- Investments designed to "promote the public welfare": § _.13(a)(2)
- Qualified Rehabilitation expenditures: § _.13(a)(3)
- Certain permitted covered fund activities and investments outside of the United States: § _.13(c)
- A covered fund that is an issuer of asset-backed securities: § _.13(d)
- Bank-owned life insurance and "certain other covered funds" § _.14(a)

In order to avoid cases where banking entities would be allowed to lend (or impose) their name to the above investments, § _.10(b)(5)(iii) should be removed from the definition of "sponsor."

**Question 243. Do the proposed rule's other definitions in § _.10(b) effectively implement the statute? What alternative definitions might be more effective in light of the language and purpose of the statute? Are additional definitions needed, and if so, what definition(s)?**

We urge the Agencies to include in the Final Rule a new definition for § _.10(b)(3(ii) that will redefine ownership interest to **include** carried interest. Carried interest was not mentioned in the

[206] Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions. 75 Fed. Reg. 75,432, 75,433 (proposed Dec. 3, 2010) (to be codified at 17 C.F.R. pts. 23 and 190).

statute. Instead, it seems that the Agencies have taken the recommendation made in SIFMA's letter from April 14th, 2011[207] that "carried interest should not be treated as an ownership interest aggregated with a banking entity's co-investments for purposes of the *de minimis* limits." We do not believe that the NPR's exclusion of carried interest in any way implements the statute. Instead, it simply acquiesces to a request made by the industry that the statute was meant to regulate. For a further discussion of the problems with carried interest as an ownership interest, including its affect on the safety and soundness of the banking entity and the financial stability of the United States, we refer the Agencies to our answer to Question 234.

We further ask that the Agencies strike "financing" from the definition of prime brokerage transaction as outlined in § _.10(b)(4). The statute very clearly laid out the fact that Sections 23A and 23B of the Federal Reserve Act would be used for the purpose of prohibiting "covered transactions" between a banking entity and a covered fund. One of the covered transactions described in 23A is "a loan or extension of credit."[208] We feel that including "financing" in the definition of a prime brokerage transaction violates the very explicit wording of the BHC Act Section 13(f)(1).

**Question 244. Is the proposed rule's approach to implementing the exemption for organizing and offering a covered fund effective? If not, what alternative approach would be more effective and why?**

The language of § _.11(e), which prohibits a banking entity from guaranteeing a covered fund, and the mandate for disclosures to investors provided in § _.11(h) are effective and consistent with the statute.

However, § _.11 could be further improved by amending the language of § _.11(e) to include the stronger wording of § _.11(h), as we suggest in our answer to Question 251.

The allowances for bank employee investments in covered funds in § _.11(g) should also be amended. While personal investments in covered funds by banking entity employees acting as investment advisors is allowed by the statute, we urge the Agencies to utilize their authority as provided in BHC Section 13(d)(2)(A) to attribute any employee investments in a covered fund to the banking entity itself, *regardless of the source of funds*, as suggested in our answer to Question 216. Further, we find that the inclusion of "or other services" in the wording of § _.11(g) opens the Rule to excessive employee investments in covered funds that were never meant to be allowed by the statute. Thus, "or other services" must be removed from § _.11(g) in the Final Rule. Please see our answer to Question 254 for further discussion of this issue.

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[207] SIFMA's Comment Letter in Advance of Notice of Proposed Rulemaking Implementing the Private Funds Portion of the Volcker Rule 9 (Apr. 14. 2011), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=24745 [hereinafter SIFMA Comment].
[208] 12 U.S.C. § 371c(b)(7)(a).

**Question 245. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?**

For further discussion, please see Question 244.

**Question 246. Is the proposed rule's approach to implementing the scope of bona fide trust, fiduciary, investment advisory and commodity trading advisory services consistent with the statute? If not, what alternative approach would be more effective? Should the scope of such services be broader or, in the alternative, more limited? Are there specific services which should be included but which are not currently under the proposed rule?**

The NPR's approach to § _.11(a) and (b) is **not** consistent with the statute. The statute provides for "bona fide trust, fiduciary, or investment advisory services."[209] By contrast, the NPR includes in its scope bona fide, trust, fiduciary, investment advisory **and commodity trading advisory** services. Thus, the scope of the services listed in the NPR is too broad, and must be limited to **only those services** initially outlined by the statute.

We do not believe that there are any other services which should be included that were not expressly mentioned in the statute.

**Question 247. Does the proposed rule effectively implement the "customers of such services" requirement? If not, what alternative approach would be more effective and why? Is the proposed rule's approach consistent with the statute? Why or why not? How do banking entities currently sell or provide interests in covered funds? Do banking entities rely on a concept of "customer" by reference to other laws or regulations, and if so, what laws or regulations?**

This requirement is ineffective because the Rule fails to otherwise define "customer" with respect to this rule. We propose here a definition of customer, drawing from the definition of "Customer relationship" provided in Title 12: Banks and Banking:[210]

> Customer means an investor engaged in a continuing, direct, and pre-existing relationship with a banking entity where a banking entity provides one or more financial products or services to the investor.

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[209] 12 U.S.C. § 1851(d)(1)(G)(i), (ii).

[210] *See* 12 C.F.R. § 216.3(i)(1) (2011) ("Customer relationship means a continuing relationship between a consumer and you under which you provide one or more financial products or services to the consumer that are to be used primarily for personal, family, or household purposes.").

It has been made very clear that the statute seeks to exclusively protect the relationships between banking entities and their customers in the implementation of this Rule. The great regulatory advantages that customer-facing activity attains in this Proposed Rule suggest that banking entities may attempt to inappropriately broaden their customer bases to increase access to such preferential regulatory treatment. Therefore, the Agencies must be diligent and specific in their indication of exactly what would constitute an appropriate customer relationship, and our recommendation is to follow the contours of the definition provided above.

**Question 249. Should the Agencies consider adopting a definition of "customer of such services" for purposes of implementing the exemption related to organizing and offering a covered fund? If so, what criteria should be included in such definition? For example, should the customer requirement specify that the relationship be pre-existing? Should the Agencies consider adopting an existing definition related to "customer" and if so, what definitions (for instance, the SEC's "pre-existing, substantive relationship" concept applicable to private offerings under its Regulation D) would provide for effective implementation of the customer requirement in section 13(d)(1)(G) of the BHC Act? If so, why and how? How should the customer requirement be applied in the context of non-U.S. covered funds? Is there an equivalent concept used for such non-U.S. covered fund offerings?**

Yes. Customer should be defined as a party having a direct, pre-existing relationship with the banking entity in the applicable type of security, or a party that initiates a new direct relationship with the bank. See a further discussion of this in Question 250.

The FSOC points to two examples of existing regulatory definitions of customer that are contextual in this case:

> Agencies should consider developing and issuing regulations to clarify the meaning of—customer in the context of this permitted activity by banking entities. The statutory language suggests that there must be a—customer relationship with a banking entity's bona fide trust, fiduciary, or investment advisory business. There are analogous statutory definitions and regulatory concepts that seek to define a customer relationship in both banking law and securities law; a prescriptive definition such as customer relationship has been used in the context of a banking entity, [Customer relationship defined as a continuing relationship between a consumer and the bank under which the bank provides one or more financial products or services to the consumer that are to be used primarily for personal, family, or household purposes. See 12 CFR 216.3 (i)(1).HEDGE FUND AND PRIVATE EQUITY FUND INVESTMENT RESTRICTIONS] while a much more nuanced definition such as—substantive

> and pre-existing relationship has been used in the context of private placements.[211]

With respect to covered funds, we find both relevant definitions serve to require that definitional customers do in fact have pre-existing relationships—either by specifying that a relationship is "continuing," which requires pre-existence, or by explicitly stating "pre-existing" within the language of the definition.

Please see Question 247 for further discussion of this issue.

**Question 250. Should the Agencies distinguish between direct and indirect customer relationships for purposes of implementing section 13(d)(1)(G) of the BHC Act? Should the rule differentiate between a customer relationship established by a customer as opposed to a banking entity? If so, why?**

The need to identify and quantify which trades are in fact customer servicing and "customer-initiated"[212] is central to the implementation of this Rule. This can only be sensibly accomplished with a clear and specific definition of customer.

Relationships that are "indirect" should never be considered legitimate customer relationships. The inclusion of "indirect" customer relationships would dilute this Rule and render it ineffective. The inclusion of indirect relationships would define a banking entity's customer base to include all direct customers, customers of their direct customers, and all iterative extensions of such. The explicit differentiation between Direct and Indirect, as well as the explicit exclusion of Indirect from the definition of customer, is essential.

We urge the Agencies to consider that banking entities will undoubtedly seek to benefit from broadening their "customer" base, through which they are able to make use of the applicable exemptions within this Rule. When considered in combination with the absence of "bright-line" prohibitions of risky activities, this Rule may incentivize improper solicitation of customers by banking entities.

Finally, the FSOC specifically calls for the Proposed Rule to explicitly define the characteristics of a client, and these factors (direct vs. indirect relationships, nature of initiation) should be considered central to such a definition. Please see Question 247 for further discussion of this issue.

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[211] FSOC Study, *supra* note 54, at 63-64.
[212] *Id.* at 3.

**<u>Question 251</u>. Does the proposed rule effectively implement the prohibition on a banking entity guaranteeing or insuring the obligations or performance of certain covered funds? If not, what alternative approach would be more effective, and why?**

The language of § _.11(h)(i) should be repeated in **§ _.11(e)**.

The Rule should not simply require the banking entity to **disclose** that losses will be borne solely by investors (and not by the banking entity). Rather, the Rule should also amend § _.11(e) to **explicitly require** banking entities to pass on those losses.

Section _.11(h)(i) specifies that banks must disclose that:

> any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the covered banking entity and its affiliates or subsidiaries]; therefore, [the covered banking entity's and its affiliates' or subsidiaries'] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by the [covered banking entity and its affiliates or subsidiaries] in their capacity as investors in the [covered fund];

In order to add the language of the disclosure to the Rule itself, § _.11(e) should be amended to read (proposed text in italics):

> (e) The covered banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests, *and any losses in the covered fund will be born solely by investors in that fund, and not by the covered banking entity and its affiliates, except to the extent that they have losses attributable to their allowable ownership interests*;

**<u>Question 252</u>. Does the proposed rule effectively implement the requirement that a banking entity comply with the limitation on certain relationships with a covered fund contained in § _.16 of the proposed rule? If not, what alternative approach would be more effective, and why?**

We strongly support the "Super 23A" restriction in § _.16(a)(1). Preventing banking entities from extending credit to the covered fund is important to ensure that banking entities are not tempted to bail out a covered fund should it falter.

However, we are concerned that § _.16(a)(1) **does** allow for the **sale** of securities by a banking entity to a covered fund. The Agencies should consider a scenario where a banking entity organized, offered, and seeded a new fund, and then sold a substantial amount of assets to this new fund. We are concerned that as written, the NPR's allowance for the sale of securities by

the banking entity to the covered fund may allow for duplicitous accounting. Moreover, the unfettered ability of a banking entity to offload undesirable assets to subsidiary covered funds would only create incentives for such a banking entity to take higher levels of risk and pursue speculative assets. Thus, in addition to supporting the restrictions provided by § _.16(a)(1), we suggest that the Agencies issue an **additional** restriction that would prevent a banking entity from **selling assets** to a covered fund.

We are concerned with § _.16(a)(2)(ii), which allows banking entities to enter into prime brokerage transactions with covered funds, provided they meet the requirements of §§ _.16(a)(2)(ii)(A)-(C). As discussed in Question 317, we feel that the banking entities should not be allowed to act as Prime Broker for a covered fund they maintain an ownership interest in. However, we recognize that the statute seems to allow for this, and thus we strongly suggest that the permitted prime brokerage transactions should not include securities lending and borrowing.

We support the annual CEO certification required by § _.16(a)(2)(ii)(B). We feel that CEO certification should be required in other areas, as discussed in our answer to Question 213.

We have serious concerns with § _.16(a)(2)(ii)(C), as it has inverted the language of the statute. We feel that the original language of the statute should be preserved. Please see our discussion of this in our answer to Question 314.

We strongly support the requirements outlined in §§ _.16(b) and _.16(c), which require that services and transactions between the banking entity and a covered fund to be on market terms or on terms at least as favorable to the banking entity and the covered fund "as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies."[213] Were §§ _.16(b) and _.16(c) not present in the Rule, a banking entity could sell distressed assets to a covered fund at above-market prices.

We ask that the Agencies consider the following scenario: A banking entity organizes and offers a new covered fund. An employee of the banking entity acts as investment advisor to the fund. The banking entity seeds the new fund with $300 million, as is the banking entity's right during the seed period. Let us assume this banking entity still holds on its books a number of asset-backed securities from the 2008 crash that have declined in value considerably. Were § _.16(b) not in place, the banking entity could sell $300 million of such assets to the covered fund at above-market rates, with the collusion of the investment advisor/banking entity employee. The banking entity will have avoided needing to realize losses on the distressed assets. After a year, the banking entity could close down the covered fund at a loss, and realize tax benefits due to write-offs.

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[213] 12 U.S.C. § 371c–1(a)(1)(A).

Thus, it is very important to retain §§ _.16(a)(1), _.16(b) and _.16(c) in order to prohibit abuses of the covered fund exemptions.

**Question 253. Does the proposed rule effectively implement the prohibition on a covered fund sharing the same name or variation of the same name with a banking entity? If not, what alternative approach would be more effective and why?**

We support the prohibition against a covered fund using the same name as a banking entity, as provided in § _.11(f).

However, § _.11(f) is not enough, and the Rule requires additional restrictions. Because the definition of sponsor expressly includes sharing the same name with a covered fund, and banking entities are allowed in numerous cases to sponsor certain covered funds, the Proposed Rule has baked-in loopholes that will allow for covered funds and banking entities to share the same name.

The definition of sponsor in § _.10(b)(5)(iii) contains the following language: "To share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name."

A banking entity is allowed to act as "sponsor" to:

- SBICs; § _.13(a)(1)
- Investments designed to "promote the public welfare"; § _.13(a)(2)
- Qualified rehabilitation expenditures; § _.13(a)(3)
- Certain permitted covered fund activities and investments outside of the United States; § _.13(c)
- A covered fund that is an issuer of asset-backed securities; § _.13(d)
- Bank-owned life insurance and "certain other covered funds"; § _.14(a)

In all of these cases, nothing disallows these exempted covered funds or investments from sharing the same name with a banking entity. This should not be permitted. The language as it stands would allow a banking entity to invest in, and then name after itself, a low-income housing project or an SBIC. If a banking entity sponsors rehabilitation of an historic structure, will that historic structure now bear the banking entity's name? Free advertising and PR should not be a reward for "promoting the public welfare."

Thus, the prohibition against a covered fund using the same name as a banking entity provided in § _.11(f) should, for the sake of clarity and emphasis, be added to every single section that allows a banking entity to act as sponsor.

The **only** section that explicitly prohibits a covered fund from sharing its name with a banking entity is § _.11. However, § _.11 does not actually use the word "sponsor" when describing the permitted activities, which is appropriate given what § _.11(f) expressly forbids:

> The covered fund, for corporate, marketing, promotional, or other purposes:
> (1) Does not share the same name or a variation of the same name with the covered banking entity (or an affiliate or subsidiary thereof); and
> (2) Does not use the word 'bank' in its name;

Again, for the sake of clarity, § _.11(f) should not be the only exemption that prohibits name sharing. The Rule should be amended to include the language of § _.11(f) in every single section that allows a banking entity to act as sponsor.

**Should the prohibition on a covered fund sharing the same name be limited to specific types of banking entities (e.g., insured depository institutions and bank holding companies) or only to the banking entity that organizes and offers the fund, and if so why?**

The prohibition on a covered fund sharing the same name should not be limited in any way. As discussed in the first part of the answer, any fund that a banking entity may retain an ownership interest in must be barred from sharing the same name.

**Question 254. Does the proposed rule effectively implement the limitation on director or employee investments in a covered fund organized and offered by a banking entity?**

No. For further discussion, please see Question 216.

**If not, what alternative approach would be more effective and why?**

A separate short-form disclosure sheet should be provided in plain English. This document should not be hidden within the offering documents.

**Should the Agencies provide additional guidance on what "other services" should be included for purposes of satisfying § _.11(g)? Why or why not?**

Rather than providing guidance on what "other services" should be included, we feel strongly that the Agencies should remove the phrase "other services" from § _.11(g). The alleged purpose of the employee investment is to ensure that the investment advisor has "skin in the game." The statute mentions no services other than investment advisory services, so the Proposed Rule is without authority in granting an exemption for "other services." In any case, non-advisor banking entity employees have no need to maintain any "skin in the game" as non-advisors would not be in the business of convincing potential investors to invest in the fund. The vague phrase "other services" in § _.11(g) could allow directors or other high-ranking

employees, who may wish to earn profit on the fund's performance, to provide a minimum consulting "service" (perhaps spending an hour on the phone or in an official meeting), and thereby meet the criteria for the undefined "other services." This opportunity for back-door investment by non-advisor bank employees has great potential to pollute the intent of Subpart C's restrictions. Thus, rather than providing additional guidance, we strongly suggest that "other services" be removed.

Please see our answer to Question 216 for further discussion of this issue.

**Question 255. Are the disclosure requirements related to organizing and offering a covered fund appropriate? If not, what alternative disclosure requirement(s) should the proposed rule include? Should the Agencies consider adoption of a model disclosure form related to this requirement? Does the timing of the proposed disclosure requirement adequately address disclosure to secondary market purchasers?**

In addition to the language already present, the Proposed Rule should also include a requirement that the disclosure be issued in plain English.

Section _.11(h)(1)(iv) should be also amended to remove the words "sponsoring or." Instead, it should state simply: "The role of the covered banking entity and its affiliates, subsidiaries and employees in providing any services to the covered fund."

"Sponsoring" must be removed from the disclosure because a covered banking entity is **not permitted** to sponsor a covered fund by § _.11, which only provides for:

> directly or indirectly, organizing and offering a covered fund, including serving as a general partner, managing member, trustee, or commodity pool operator of the covered fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund, including any necessary expenses for the foregoing

The word "sponsor" does not appear in this exemption, and so the requirement to disclose that a banking entity may sponsor the covered fund is inaccurate and should not be allowed by the Proposed Rule.

**Question 256. Is the proposed rule's approach to implementing the exemption that allows a banking entity to make or retain a permitted investment in a covered fund effective? If not, what alternative approach would be more effective and why?**

The NPR's delineation of permitted investments in covered funds falls short in two categories: the one year seed investment period, and the language of the exemptions for loan securitizations.

These shortcomings leave the Rule at risk of evasion and stand in contrast with Congressional intent.

Section _.12(a)(1)(i) allows for a one-year period wherein a banking entity may seed covered funds up to a maximum 3% of the bank's Tier 1 capital. For context, in Q3 2011, 3% of Goldman Sachs's Tier 1 Capital measured **$1.89 billion**.[214] The terms of § _.12(a)(1)(i), allowing the banking entity to provide "sufficient initial equity" provide no guidance as to what a "sufficient" investment means.

The Proposed Rule's failure to define a specific limit on initial capital during the seed period runs contrary to the intent and "general rule" outlined by Sen. Merkley in the Congressional Record. To properly follow Congressional intent, the initial seed investment period must be limited to a $10 million investment, or 3% of Tier 1 Capital, whichever is less. Failure to give such specific guidance as to the scope and limits of the investments made during the seed period leaves enormous potential for exploitation and abuse of the intent of the Rule. For an in-depth discussion of this issue, please see Question 259.

The second shortcoming is the language in the exemptions for loan securitizations in § _.13(d) and § _.14(a). Both contain the same dangerous item that allows not just for loans but also for "contractual rights or assets directly arising from those loans supporting the asset-backed securities." For an in-depth discussion of this issue, please see Question 303.

**<u>Question 257</u>. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?**

Section _.12(a)(2)(i)(B)'s seed investment period of up one year should be limited to six months, with a possible extension upon application to the Board, as outlined in Section 13(d)(4)(C) of the BHC Act. Further, the one year seed investment period should be limited to a maximum investment of $10 million, or 3% of Tier 1 capital, whichever is less, in order to align with explicitly stated Congressional intent.

See Questions 256 and 259 for discussion of the suggested removals and revisions specified above.

**<u>Question 258</u>. Should the proposed rule specify at what point a covered fund will be considered to have been "established" for purposes of commencing the period in which a**

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[214] *See* The Goldman Sachs Group, Inc., Form 10-Q, Third Quarter 2011, at 77 (Sep. 30, 2011). *available at* http://www2.goldmansachs.com/investor-relations/financials/current/10q/10-q-3-q-2011-pdf.pdf (noting that Goldman Sachs had a total of $63.1 billion in Tier 1 Capital total as of Q3 2011).

**banking entity may own more than 3 percent of the total outstanding ownership interests in such fund? If so, why and how?**

The Proposed Rule should be amended to state that a fund is "established" as soon as (1) incorporating documents have been filed by the fund, or (2) the covered fund has received their first investment, whichever comes first.

**Question 259. Does the proposed rule effectively implement the requirement that a banking entity comply with the limitations on an investment in a single covered fund? If not, what alternative approach would be more effective and why?**

A better approach to limiting investments in a single covered fund would be to cap Assets under Management to $10 million, or the bank's 3% Tier 1 capital limit, whichever is less. Such was the guidance given by Congress, as we can see from Sen. Merkley's testimony in the Congressional Record on how the seeding period should work:

> As a general rule, firms taking advantage of this provision should maintain only small seed funds, likely to be **$5 to $10 million or less**. **Large funds** or funds that are not effectively marketed to investors **would be evasions of the restrictions of this section**.[215]

Such a limitation will make the banking entities invest in smaller funds with less risk concentration. Failure to follow Congress's intent to only allow banking entities to seed small funds has the potential to create a new cottage industry of large bank-run hedge funds, where a fund lasts for only one year, is seeded entirely by the bank, effectively run by a bank employee who may also make a personal investment in the fund, and then closed down after a year, only for the process to begin anew under the guise of a new fund. While the bank is limited to an aggregate of 3% of Tier 1 capital, for a banking entity like Morgan Stanley, this amounts to $1.58 billion as of Q3 2011.[216]

In addition, the unlimited seed investment allowance for the first year poses a great systemic risk. The market will know that any banking entity organizing and offering a new covered fund must divest by the end of one year. Allowing for an unlimited initial seed investment creates a risk that this new fund will enter into a LTCM-like death spiral as the one-year limit approaches.

Assume that a banking entity has only a sole covered fund investment: a fund that it offers and organizes. The banking entity invests the maximum allowed, 3% of Tier 1 capital, to the tune of

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[215] *Id.*

[216] *See* Morgan Stanley, Form 10-Q, Third Quarter 2011, at 70 (Sep. 30, 2011), *available at* http://www.morganstanley.com/about/ir/shareholder/10q0911/10q0911.pdf (noting that Morgan Stanley had a total of $52.7 billion in Tier 1 Capital as of Q3 2011).

$1 billion or more. Assume that the fund takes that money and invests in assets. If the covered fund is unable, as the end of the year approached, to drum up outside investment, it will need to sell those assets. But as happened to LTCM, it is very likely that the covered fund's assets may be known to the market. As Richard Bookstaber describes in his book, *A Demon of our own Design: Markets, Hedge Funds and the Perils of Financial Innovation*:

> [LTCM's] positions were also well-known. While Meriwether and company made an elaborate show of their secrecy, they traded in huge size and trumpeted their acumen with panache.[217]

The fact that a banking entity needs to divest at the end of year will be a fact known to all market participants. If the positions of the fund are known, or become known as the fund begins to sell assets so the banking entity may divest, the market may move against the fund, causing a bleak downward spiral. This is what happened to LTCM:

> Most dealers and large hedge funds knew LTCM was short of cash and would need to sell, and they knew what it would sell. No one wanted to be first to take the other side of those sales. In fact, some started to move out of their positions ahead of the expected stampede. []As a result, LTCM had to drop prices dramatically to find buyers. By the time it raised enough cash from selling assets to post the higher margin required by the creditors of its Russian positions, the prices had dropped so far on the rest of its portfolio that the remaining inventory was worth substantially less. The banks providing margin for that inventory, in turn, demanded larger haircuts. LTCM was caught in an irreversible downward cycle driven by its high leverage.[218]

Similar to the scenario above, the covered fund will be compelled to desperately sell assets to have sufficient funds to redeem the banking entity's massive seed investment upon the bank's required divesture. Additionally, as we discussed in Question 241, the covered fund may also be leveraged, perhaps even through financing from the banking entity itself, because the prime brokerage definition permits "financing" as currently written in § _.10(b)(4).

The divestment at the end of the year, being a known end date, may cause substantial risk to the system if the covered fund's need to sell assets leads other firms to liquidate the same assets. Bookstaber outlined this possibility when describing a fund selling assets in response to a price shock:

> Depending on the price elasticity of the liquidity supply, we could end up without convergence because the price would have to move so far to elicit sufficient

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[217] Richard Bookstaber, *Demon of our own Design* 94 (John Wiley & Sons. Inc. 2007).
[218] *Id.* at 104.

> supply that the fund would have to sell an ever-increasing proportion of its remaining assets. The cycle would become a market crisis as the drop in the market price led to similar needs to liquidate at other firms.[219]

Whether it be in response to a price shock or simply a required divestment, a mass sale of assets that is anticipated by the market as the one year seed period winds down could lead to system shocks or market crises if the initial seed investment were large enough, and other firms held positions similar to those in the covered fund. The clearest and safest way to avoid adding such market volatility is to severely limit the amount that banking entities may invest in the seed period. Tight restrictions to the investments allowed during the seed period match Congressional intent, as we have discussed above, since Senator Merkley expected that seeds would be small and large funds "would be evasions of the restrictions."[220]

Thus, the Agencies must redefine § _.12(a)(2)(i) by adding a new entry, § _.12(a)(2)(i)(C) requiring that the one year seed investment period be limited to a maximum investment of $10 million, or 3% of Tier 1 capital, whichever is less. Please see this suggested addition in *Annexure B*. This new ownership limitation must be added in order to not create new risks to banking entities or to the financial system as a whole, as outlined in Sections 13(2)(A)(iii) and (iv) of the BHC Act.

In addition to a firm cap on the amount of the initial seed investment, the Agencies should require that the bank reach the 3% per-fund limit in six months. The statute says "not later than 1 year"[221] but the Agencies have the authority to impose stricter limits. The Congressional Record says that a bank's investment in a covered fund should be limited "to the size only necessary to facilitate asset management businesses for clients."[222] The Agencies should apply a presumption that six months is sufficient time for the fund to get capitalized. If a banking entity wants an extension from six months to the statutory one-year mark, it should apply for an extension along the same lines as outlined in Section 13(d)(4)(C) of the BHC Act. If banks need a further extension beyond one year, they can apply for further extensions pursuant to Section 13(d)(4)(C). This second-level extension should be granted in few cases.

A canonical understanding of *Vermont Yankee*, a seminal administrative law case, is that agencies may adopt additional procedures beyond the statutory minima set by Congress.[223] Here, the "up to one year" language is an upper limit, not a fixed timeframe, and the Agencies may impose a stricter timeframe in keeping with the Congressional intent that the "'de minimis' investments are to be greatly disfavored."[224]

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[219] *Id.* at 94-95.
[220] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (emphases added).
[221] 12 U.S.C. § 1851(d)(4)(B)(ii)(II).
[222] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).
[223] *See* Jack M. Beermann & Gary Lawson, *Reprocessing* Vermont Yankee. 75 Geo. Wash. L. Rev. 856, 858 (2007).
[224] *Id.*

**<u>Question 261</u>. Is the proposed rule's approach to calculating a banking entity's investment in a covered fund effective? Should the per-fund calculation be based on committed capital, rather than invested capital? Why or why not?**

The per-fund calculation should be based on both committed and invested capital. Committed funds, even if not yet called for investment, are a contractually guaranteed outflow from the bank's coffers. From a prudent accrual-based accounting perspective, the money is as good as gone. A covered fund that runs into financial trouble could try to sue the banking entity to gain access to those funds. Committed-yet-uncalled funds have already been allocated by the bank, and depositors face the risk of having to make up for that amount if the fund fails. Our proposed revision would also make Volcker Rule compliance easier, as a banking entity would not need to re-assess its compliance every time committed funds are incrementally disbursed to the covered fund. Accordingly, we recommend the following changes to the Proposed Rule (with italicized language representing additional terms):

> § _12(b)(2)(i): The aggregate amount of all ownership interests of the covered banking entity shall be the greater of ~~(without regard to committed funds not yet called for investment)~~:
>
> § _.12(b)(2)(i)(A): The value of any investment or capital contribution made with respect to all ownership interests held under § _.12 by the covered banking entity in the covered fund, *including committed funds not yet called for investment,* divided by the value of all investments or capital contributions, respectively, made by all persons in that covered fund, *including committed funds not yet called for investment*;

**Is the timing of the calculation of a banking entity's ownership interest in a single covered fund appropriate? If not, why not, and what alternative approach would be more effective and why? For example, should the per-fund calculation be required on a less-frequent basis (e.g., monthly) for funds that compute their value and allow purchases and redemptions on a daily basis (e.g., daily)? Why or why not?**

There is no reason to allow for a mismatch between the timing of the single covered fund investment calculation and a covered fund's calculation of purchases and redemptions. Such purchases and redemptions are likely derived electronically, and there is no marginal cost to adding a metric that ensures per-fund compliance. In fact, allowing for disparate standards would likely raise the burdens of compliance, since a new timing rule would essentially be created.

**<u>Question 262</u>. Is the proposed rule's approach to parallel investments effective? Why or why not? Should this provision require a contractual obligation and/or knowing**

**participation? Why or why not? How else could the proposed rule define parallel investments? What characteristics would more closely achieve the scope and intended purposes of section 13 of the BHC Act?**

The Proposed Rule is effective to the extent that it recognizes that parallel investments in covered funds can occur both through direct contractual obligations, and through unwritten joint activity. However, the Rule is weakened by its imposition of a knowingness standard. As we have argued elsewhere, the Volcker Rule imposes a strict liability rubric on banking entities. Whether joint activity or parallel action toward a common goal of investing in a covered fund is knowing or unknowing is immaterial. The potential harm to be felt by depositors, investors, consumers and taxpayers is the same regardless of the banking entity's intent. Thus, we recommend that the word "knowing" be struck from § _.12(b)(2)(ii).

**Question 263. Is the proposed rule's treatment of investments in a covered fund by employees and directors of a banking entity effective? If not, what alternative approach would be more effective and why?**

No. For further discussion, please see Question 216.

**Question 264. Is the proposed rule's approach to differentiating between controlled and noncontrolled investments in a covered fund unduly complex or burdensome? If so, what alternative approach, if any, would be more effective and why?**

The Proposed Rule's approach to differentiating between controlled and noncontrolled investments in a covered fund is effective because it reduces opportunities for evasion through the utilization of subsidiaries, affiliates or related entities.

**Question 265. Is the proposed rule's approach to valuing an investment in a covered fund according to the same standards utilized by the covered fund for determining the aggregate value of its assets and ownership interests effective? If not, what alternative valuation approach would be more effective and why? Should the rule specify one methodology for valuing an investment in a covered fund?**

The Proposed Rule's approach to valuing an investment in a covered fund according to the same standards utilized by the covered fund is effective and appropriate, except to the extent that committed-yet-uncalled funds are excluded from the valuation. Such funds must be included in the calculation, as discussed in Question 261.

Further, we recommend the following changes to the Proposed Rule (with italicized language representing additional terms):

> § _.12(b)(4): Methodology and standards for calculation. For purposes of determining the amount or value of its investment in a covered fund under this paragraph (b), a covered banking entity must calculate its investment in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests, *except that committed funds not yet called for investment shall be counted toward the value of the total investment in the covered fund regardless of the standards used by the covered fund.*

Additionally, we recommend that the Agencies add language to the regulation mandating that any valuation by conducted under Generally Accepted Accounting Principles (GAAP), in order to minimize the risk of evasion of the per-fund restriction through accounting manipulation.

**Question 266. Is the proposed rule's approach regarding when to require the calculation of a banking entity's aggregate investments in all covered funds effective? What is the potential impact of calculating a banking entity's aggregate investment limit under the proposed rule on a quarterly basis as opposed to solely at the time an investment in a covered fund is made? Would calculation of the aggregate investment limit solely at the time an investment in a covered fund is made be consistent with the language and purpose of the statute? Does the proposed rule provide sufficient guidance for an issuer of asset-backed securities about how and when to make such calculation? Why or why not?**

Calculating an aggregate investment solely at the time an investment in a covered fund is made would not be effective or consistent with the statute. There should be a continuing calculation. The purpose of the statute is for investment to "be immaterial"[225] not "initially be immaterial." The statute also clearly states that "*in no case* may the aggregate of all of the interests of the banking entity in all such funds exceed 3 percent of the Tier 1 capital."[226] Allowing the calculation to occur only at the time of the investment would violate the statutory demand that "in no case" may the aggregate investments exceed 3% of Tier 1.

In addition, the Agencies should ensure that any increase in the aggregate investment due to capital appreciation would still increase the bank's gross exposure to the fund. Should capital appreciation cause a banking entity to exceed its aggregate limit, the bank must divest from its covered funds until it lowers its exposure back to or below the 3% aggregate limit.

**Question 267. Is the proposed rule's approach to determining and calculating a banking entity's relevant tier 1 capital limit effective? If not, what alternative approach would be more effective and why? With respect to applying the aggregate funds limitation to a banking entity that is not affiliated with an entity that is required to hold and report tier 1**

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[225] 12 U.S.C. § 1851(d)(4)(B)(ii)(II).
[226] *Id.* (emphasis added).

**capital, is total shareholder equity on a consolidated basis as of the last day of the most recent calendar quarter that has ended an effective proxy for tier 1 capital? If not, what alternative approach would be more effective and why?**

The approach contained in the Proposed Rule is effective. Allowing Tier 1 capital to be computed on a consolidated basis would inappropriately expand the amount of ownership allowed beyond the 3% aggregate limit. The top-tier entity is most relevant for this purpose because subsidiary entities are essentially legally distinct by operation of Federal Reserve Act Sections 23A and 23B. The equity of subsidiaries is not as much at risk, may not be available to address any liquidity deficiencies, and should therefore not be considered relevant for purposes of calculating the 3% aggregate limit.

**Question 268. Should the proposed rule be modified to permit a banking entity to bring its investments in covered funds into compliance with the proposed rule within a reasonable period of time if, for example, the banking entity's aggregate permitted investments in covered funds exceeds 3 percent of its tier 1 capital for reasons unrelated to additional investments (e.g., a banking entity's tier 1 capital decreases)? Why or why not?**

The rule should **not** allow a banking entity any additional time for compliance if its investment exceeds 3% for any reason. To do otherwise would strongly contradict the wording of the statute. The statute says "in no case"[227] may the aggregate investment exceed 3%. The reasons for a change in the investment amount are immaterial. Divestment or dilution should occur by the next quarter.

**Question 269. Does the proposed rule effectively and appropriately implement the deduction from capital for an investment in a covered fund contained in section 13(d)(4)(B)(iii) of the BHC Act? If not, what alternative approach would be more effective or appropriate, given the statutory language of the BHC Act and overall structure of section 13(d)(4), and why? What effect, if any, should the Agencies give to the cross-reference in section 13(d)(4) to section 13(d)(3) of the BHC Act, which provides Agencies with discretion to require additional capital, if appropriate, to protect the safety and soundness of banking entities engaged in activities permitted under section 13 of the BHC Act? How, if at all, should a banking entity's deduction of its investment in a covered fund be increased commensurate with the leverage of the covered fund? Should the amount of the deduction be proportionate to the leverage of the covered fund? For example, instead of a dollar-for-dollar deduction, should the deduction be set equal to the banking entity's investment in the covered fund times the difference between 1 and the covered fund's equity-to-assets ratio?**

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[227] *Id.* at § 1851(d)(4)(B)(ii)(2).

The Proposed Rule is effective to the extent that it requires a dollar-for-dollar deduction from capital for investments in covered funds. The fund's equity-to-assets ratio should not be considered because most funds have limited transparency as to their accounting methods and practices. A fund may not calculate leverage as frequently or as thoroughly as would be required of a banking entity. Furthermore, the relatively small size of a covered fund would engender manipulation of numbers to facilitate evasion of the investing bank's capital adequacy requirements. A banking entity's capital requirements should be based on clear, easy to understand reference points such as the dollar-for-dollar standard promulgated in the Proposed Rule.

We concede that the Supplementary Information is correct in stating that, as per the relevant statutory language in Section 13(d)(4)(C) of the BHC Act, the deduction requirement contained in § _.12(d) would not explicitly apply to exempted activities under § _.13. Nevertheless, the Agencies have been afforded authority under Section 13(d)(3) of the BHC Act to impose additional capital requirements if necessary to protect the safety and soundness of banking entities. We recommend that any of the activities exempted in § _.13 (under the authority afforded by Section 13(d)(1)(J) of the BHC Act) be subject to the dollar-for-dollar deduction requirement as well.

It can be argued that such was the intent of Congress, as both Sections 13(d)(3) and 13(d)(1)(J) of the BHC Act refer to the protection of the safety and soundness of banking entities. The simple fact is that the Agencies cannot ensure, with 100% certainty, that the activities exempted under § _.13 will not pose grave risks to particular banking entities in certain instances in the future. Thus, it would behoove the Agencies to address this risk by imposing capital requirements, in the form of a dollar-for-dollar deduction, for these exempted activities as well.

**Question 270. Does the proposed rule effectively implement the Board's statutory authority to grant an extension of the period of time a banking entity may retain in excess of 3 percent of the ownership interests in a single covered fund? Are the enumerated factors that the Board may consider in connection with reviewing such an extension appropriate (including factors related to the effect of an extension of the covered fund), and if not, why not? Are there additional factors that the Board should consider in reviewing such a request? Are there specific additional conditions or limitations that the Board should, by rule, impose in connection with granting such an extension? If so, what conditions or limitations would be more effective?**

Section _.12(e) effectively implements the statutory provision for extensions contained at Section 13(d)(4)(C), except that it should also make clear that a banking entity may not consecutively avail of the two-year extension allowed under Section 13(d)(4)(C), the five-year extension for illiquid funds and the possible three years of single-year extensions. Rather, banking entities should be required to **choose one** of these three extension options. Nothing in the Congressional Record or the BHC Act stipulates that banking entities should be able to avail

of these extension periods consecutively. Absent our proposed modification, the Rule would allow banking entities to utilize the delayed conformance period and various available extensions to delay compliance with the per-fund limitation until the year 2024, which would make a mockery of the Volcker Rule.[228] The U.S. could easily suffer another recession or depression caused by risky bank conduct well before the year 2024, which is why the Agencies should require strict compliance as soon as statutorily possible.

**Question 271. Given that the statute does not provide for an extension of time for a banking entity to comply with the aggregate funds limitation, within what period of time should a banking entity be required to bring its investments into conformance with the aggregate funds limit? Should the proposed rule expressly contain a grace period for complying with these limits? Why or why not? If yes, what grace period would be most effective and why?**

There should be no grace period. The Rule already has a long conformance period and various extensions built in.

The extension provided by § _.13(d)(4)(C) serves only the interests of the banks. Such a grace period effectively neuters this regulation by permitting long periods of non-conformance.

The statute enumerates not only three 1-year extensions but also a 5-year extension. If these are granted consecutively, it could result in delays for up to 10 years (considering the 2-year initial conformance period) from the implementation of the Rule. These exemptions should be considered cumulative: a firm obtaining three 1-year extensions should only be allowed to gain an additional 2 years of extension by applying for the 5-year extension.

**Question 272. Does the proposed rule effectively implement the prohibition on a banking entity guaranteeing or insuring the obligations or performance of certain covered funds? If not, what alternative approach would be more effective and why?**

This is a duplicate of Question 251. See our answer to Question 251.

**Question 273. In the context of securitization transactions, control and ownership are often completely separated. Is additional guidance necessary with respect to how control should be determined with respect to issuers of asset-backed securities for purposes of determining the calculation of the per-fund and aggregate ownership limitations?**

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[228] Further, as we discuss below, the combination of the conformance period and the various extensions would allow banks to delay compliance with requirements other than the per-fund limitation to as late as July 21, 2022. *See* Andrew Clark, *US Banks Off the Hook Until 2022*, The Guardian, Jun. 29, 2010. Once again, banking entities should not be allowed to utilize the extensions consecutively, but rather should be forced to choose one type of extension.

Please see our answers to Questions 237 and 240.

**Question 274. In many securitization transactions, the voting rights of investors are extremely limited and management may be contractually delegated to a third party (because issuers of asset-backed securities rarely have a board with any authority or any employees). The servicer or manager has the "ability to control the decision-making and operational functions of the fund." When calculating the per-fund and aggregate ownership limitations, to whom should the proposed rule allocate "control" in this type of situation? Which participants in a securitization transaction would need to include the activities of an issuer of asset-backed securities in their calculations of per-fund and aggregate ownership, and what is the potential impact of such inclusion?**

Please see our answers to Questions 237 and 240.

**Question 275. For purposes of calculating the per-fund and aggregate ownership limitations, how should the proposed rule address those instances in which equity is issued, but the equity holder does not receive economic benefits or have any control rights? For instance, in order to enhance or achieve bankruptcy remoteness, a single purpose trust without an owner (i.e., an orphan trust) may hold all of the equity interests in a securitization vehicle. Such interests often do not have any meaningful economic or control rights.**

Please see our answers to Questions 237 and 240.

**Question 276. Is the proposed rule's approach to implementing the SBIC, public welfare and qualified rehabilitation investment exemption for acquiring or retaining an ownership interest in a covered fund effective? If not, what alternative approach would be more effective?**

No, a covered fund should not acquire or retain ownership interest in a SBIC. A banking entity's community development arm/department can act as a sponsor to SBICs that perform Public Welfare activities. Banking entities can provide valuable expertise and services to these types of entities and this exemption, if properly implemented, would enable banking entities to provide critical and valuable funding and assistance to low-income communities. Many of the largest banks (e.g., J.P. Morgan, Bank of America, Wells Fargo, Citibank and others) have community development arms that are responsible for investing in SBICs and other entities that focus on the public welfare.

As a result of the Rule there may be a renewed prominence for SBICs as one of the only remaining vehicles for banking entities to utilize for proprietary trading. There are obvious risks to allowing the exemption: There is a possibility that a banking entity and/or covered fund would

misappropriate government funding tools (SBICs/tax credits) that finance these projects and make investments that do not address the public welfare and/or become vehicles through which proprietary trading can take place. Pending the outcome of the rule-making process, fund raising and new fund formation may be significantly affected as banking entities may be reluctant to commit new funds to any private equity or hedge funds. Therefore, it seems likely that SBICs will be an important tool for banking entities under the new framework, and the Agencies are reminded to stay vigilant in their oversight of SBICs, to ensure that these companies are not misused for proprietary trading purposes.

Furthermore, SBICs often are vehicles for Venture Capital firms to exploit various types of tax credits and other government subsidies for community re-investment. There are numerous examples of Venture Capital Funds/Bank Entities utilizing tax credits to develop luxury real estate. For instance, according to the Treasury Department, many Venture Capital Funds and Investment Banks have used a program called New Markets Tax Credits to help build more than 300 upscale projects, including hotels, condominiums, office buildings and a car museum, on streets far from poverty.[229] This can be seen through a variety of examples:

- The biggest beneficiary of taxpayer help for the Blackstone revamp was Prudential Financial Inc., the second-largest U.S. life insurer. The company received $15.6 million in tax credits from the U.S. Department of the Treasury for helping to fund the project, according to Chicago city records.
- JPMorgan Chase & Co., the second-largest U.S. bank by assets, also took in money by serving as a lender and the monitor of Blackstone construction financing, Chicago city records show.
- Since 2003, some of the world's biggest financial companies, including Goldman Sachs Group Inc., U.S. Bancorp, J.P. Morgan Chase and Prudential, have taken advantage of a federal subsidy that will cost taxpayers $10.1 billion—and most of the public has never heard of this subsidy.[230]

In light of this recent trend of misuse, we urge the Agencies to consider additional restrictions on the § _.13(a) exemptions.

**<u>Question 277</u>. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?**

Yes, there can be tighter restrictions imposed on what constitutes a § _.13(a) fund. The Agencies should dictate that a covered fund and/or venture capital fund cannot sponsor or retain an interest

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[229] David Dietz, *Rich Take From Poor as U.S. Subsidy Law Funds Luxury Hotels*. Bloomberg, Feb. 8, 2011. http://www.bloomberg.com/news/2011-02-08/rich-taking-from-poor-as-10-billion-u-s-subsidy-law-funds-luxury-hotels.html.
[230] *Id.*

in an SBIC or related investment company. Rather, such entities should **only** be sponsored by the parent banking entity's community development department.

Further, the Agencies should condition the exemption on actual use of invested funds for public welfare activities, small business development, low-income community use, and community development activities. Imposing these prudential limits could stop the SBICs and related funds from becoming a vehicle for proprietary trading.

The Final Rule should include these basic elements:

1. Investments in § _.13(a) companies should require strict compliance with the company's stated purpose;
2. Covered Funds should be barred from ownership of SBICs; and
3. SBIC investment must run through a community development arm of the parent banking entity.

**Question 278. Should the proposed rule permit a banking entity to sponsor an SBIC and other identified public interest investments? Why or why not? Does the Agencies' determination under section 13(d)(1)(J) of the BHC Act regarding sponsoring of an SBIC, public welfare or qualified rehabilitation investment effectively promote and protect the safety and soundness of banking entities and the financial stability of the United States? If not, why not?**

The Proposed Rule should allow a banking entity to sponsor or retain an interest in an SBIC if the purpose of the SBIC is to invest in the "public welfare" (i.e., small businesses development, low-income housing, and local economic development). The Agencies should impose requirements and develop criteria to ensure that the investment will be used to support low-income communities across the country through the development of housing, employment, education, and other opportunities. The banking entity should run the sponsorship of the SBIC through its community development/community affairs departments and only sponsor and/or invest in SBICs that promote the public welfare.

A covered fund's sponsorship in the SBIC is not necessary. While we understand that certain covered funds may have valuable expertise, skills, and capabilities that could facilitate the structuring of and investment in funds that invest in Public Welfare activities, these activities should nevertheless be conducted by the parent banking entities themselves, as the Agencies have greater visibility over banking entities pursuant to the Volcker recordkeeping provisions than over covered funds. This will help ensure that small developers and non-profits access the resources and investors that they need to promote the public welfare.

**Question 279. What would the effect of the proposed rule be on a banking entity's ability to sponsor and syndicate funds supported by public welfare investments or low income**

**housing tax credits which are utilized to assist banks and other insured depository institutions with meeting their Community Reinvestment Act ("CRA") obligations?**

The Proposed Rule does not negatively affect a banking entity's ability to meet its CRA obligations by sponsoring funds supported by public welfare investments or tax credits. The banking entity should have the ability to sponsor these types of funds but with the explicit understanding that they are engaging with funds and/or projects that revitalize and reinvest in low-income communities and promote the public welfare.

The Proposed Rule correctly identifies the area of Public Welfare Activities as one where restrictions should be relaxed, consistent with safe and sound operation of banking entities and the promotion of the financial stability of the United States. That said, effective monitoring will be required to detect evasion of intended regulations.

**Question 280. Does the proposed rule unduly constrain a banking entity's ability to meet the convenience and needs of the community through CRA or other public welfare investments or services? If so, why and how could the proposed rule be revised to address this concern?**

No, the Proposed Rule does not unduly constrain a banking entity's ability to meet the convenience and needs of communities through CRA investments. The Rule gives an exemption to allow banking entities to sponsor a fund that invests in the public welfare. As noted above, covered funds (as opposed to banking entities) should not be permitted to sponsor or retain an interest in an SBIC or related investment under § _.13(a) because unregulated covered funds have no legitimate purpose in investing in public welfare activities. This restriction on covered funds will not affect a banking entity's ability to meet the needs of communities through CRA or other public welfare investments. If the banking entity's community development department focuses its investments on the public welfare it should not be constrained or negatively impacted by the Rule.

**Question 281. Is the proposed rule's approach to implementing the hedging exemption for acquiring or retaining an ownership interest in a covered fund effective? If not, what alternative approach would be more effective?**

We do **not** believe that the NPR's approach to implementing the hedging exemption for ownership interests in a covered fund is effective. First, the approach violates the language and intent of the statute. Second, its allowances are vague enough to permit evasion of **all the limits** to covered fund investments in Subpart C through the use of § _.13(b)(1)(i)(B).

Section _.13(b)(1)(i)(B) permits banking entities to hedge liabilities directly connected to compensation arrangements for employees providing services to the covered fund. This language is neither effective nor consistent with the statute.

The statute only permits hedging if it is directly tied to a **position, contract** or **holding** of a banking entity. Section 619(d)(1)(C) of the statute reads:

> Risk-mitigating hedging activities in connection with and related to **individual or aggregate 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 statute, as shown above, contemplates "position," "contract" or "holding." Those terms are used in the Proposed Rule to refer to purchases or sales of *tradable assets*. Notably, the statute did not use "exposure" or "compensation arrangements." Further, the "positions, contracts or other holdings" language of the statute is intended to relate to items that go in the bank's trading account. An employment contract does **not** go into the trading account. Thus, § _.13(b)(2)(ii)(B)(2), § _.13(b)(1)(i)(B), and any other allowances for hedging "exposure" or "compensation arrangements" add new allowances not accounted for in the language or intent of the statute, and should be removed from the Proposed Rule entirely. A reviewing court shall hold unlawful and set aside agency action, findings, and conclusions found to be in excess of statutory jurisdiction, authority, or limitations, or short of statutory right.[231]

The second reason that the NPR's approach to implementing the hedging exemption for ownership interests in a covered fund is ineffective is because it could lead to substantial rule evasion.

The investment advisor employee makes money in up to three ways:

- Salary from the banking entity
- Carried interest
- Deferred compensation

In terms of deferred compensation, as SIFMA noted in their "Comment Letter in Advance of Notice of Proposed Rulemaking Implementing the Private Funds Portion of the Volcker Rule":

> [B]anking entities frequently establish deferred compensation programs that promise employees involved in providing asset management services the value of certain hedge funds or private equity funds if certain conditions are satisfied. Although it might be uncertain whether the conditions will be satisfied, the banking entity will nevertheless be obligated to perform if they are.[232]

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[231] 5 U.S.C. § 706.
[232] SIFMA Comment, *supra* note 207, at 15.

SIFMA's argument to the Agencies was that under a deferred compensation arrangement, an investment advisor employee may receive certain deferred compensation if the fund performs well ("certain conditions are satisfied"). Even SIFMA points out that "it might be uncertain whether the conditions will be satisfied," but the Agencies still went ahead and in the NPR gave an allowance for risk-mitigating hedging in covered funds, contemplating the need of a banking entity to pay deferred compensation. While the NPR does restrict any ownership interests taken as a "hedge" to a compensation agreement to be "in the same amount of ownership interest in the covered fund that (2) is directly connected to its compensation arrangement with an employee that directly provides investment advisory services to the covered fund," the NPR makes no qualifications of what "in the same amount" means for a compensation arrangement. What is this "hedge" based on? Is it based on the amount of profit that the fund made in the prior year? What if the fund is in its first year—is it based on the profits made in the prior quarters? Is it based on the investment advisor's own predictions? Is it based on the banking entity's predictions? This vagueness leaves open the possibility that a banking entity could take on a 100% ownership interest as a "hedge" if it expected the investment advisor employee to double or triple the fund's value that year.

Should a banking entity wish to invest in more than its allotted 3% de minimis investment, it seems that § _.13(b)(1)(i)(B) provides an easy way to accomplish that. Since the NPR has no requirement that the compensation "hedge" be reasonable or correlated to past returns of the fund, it seems the NPR would allow for complete subversion of the covered fund restrictions on ownership interests simply through the use of hedging compensation arrangements as provided in § _.13(b)(1)(i)(B).

Thus, in order to prevent rule evasion via § _.13(b)(1)(i)(B), we urge the Agencies to remove it from the Final Rule.

If the Agencies are unwilling to remove § _.13(b)(1)(i)(B) from the Final Rule, in our response to Question 284 we suggest a number of additional criteria that will help to prevent evasion through the use of this exemption.

Finally, we thought it important to mention that in creating the language of § _.13(b), which allows for investments in covered funds outside of the 3% limits under the guise of "risk-mitigating hedging," the Agencies have granted SIFMA the power to rewrite the law to its liking.

In its "Comment Letter in Advance of Notice of Proposed Rulemaking Implementing the Private Funds Portion of the Volcker Rule," SIFMA describes the compensation arrangements for investment advisors, which can include **both** carried interest and deferred compensation, as follows:

> Employees who manage these funds are typically compensated for their management of the funds by receiving a portion of the funds' profits. In addition,

> it is common practice for banking entity employees engaged in the provision of asset management services to have the choice of deferring part of their compensation and having that deferred amount be linked to the performance of the funds in which the employees are involved.[233]

SIFMA then argues that this sort of pay structure is "critical" to "the retention of banking entity employees engaged in the provision of asset management services." In order to pay these employees their deferred compensation, SIFMA informs us that:

> The banking entity then **"hedges"** that exposure by investing directly in the referenced funds.[234]

The so-called "hedging" of a deferred compensation arrangement for an employee who is already paid through carried interest is such a stretch that **even SIFMA puts "hedges" in quotes**.

SIFMA's Annex B from this letter seems to have made its way into the NPR. While the language of the NPR language differs from SIFMA's Annex B, it is clear that SIFMA was successful in its lobbying for risk-mitigating hedging of compensation arrangements in covered funds.

See also Questions 216 and 285.

**<u>Question 282</u>. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?**

As stated in Question 281, since the hedging of compensation arrangements conflicts with the language of the statute, § _.13(b)(1)(i)(B) should be removed from the Proposed Rule entirely.

However, should § _.13(b)(1)(i)(B) not be removed from the Final Rule, we have proposed several new criteria be added to § _.13(b)(2)(ii)(B)(2) that we have outlined in our answer to Question 284.

**<u>Question 283</u>. What burden will the proposed approach to implementing the hedging exemption have on banking entities? How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?**

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[233] *Id.* at 15.
[234] *Id.*

The hedging exemption is hardly a burden to the banks, given that the language of § _.13(b)(1)(i)(B) could be interpreted to allow almost any investment in a covered fund as a hedge against compensation.

Requiring documentation at the time of the trade means that, in reality, a trader will likely have to choose from a pre-set list of reasons for the hedge from a drop-down list in the trading software. Or, perhaps more likely, someone in operations will need to hunt down the trader after the fact to fill in the information, should this be missing.

The banking entities already have compliance programs in place, and adding new policies and procedures, as well as requiring documentation at the time of trade, is hardly a burden given the large leeway this exemption gives to banks to subvert the intent of Sections 619(a)(1)(B) and 619(d)(1)(C) and the Act.

**Question 284. Are the criteria included in § _.13(b)'s hedging exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other requirements be added?**

We believe that the criteria for an internal compliance program (§ _.13(b)(2)(i)), and continuous review by the banking entity's compliance group (§ _.13(b)(2)(ii)(D)) are important and should be retained for the Final Rule.

As stated in Question 281, since the hedging of compensation arrangements conflicts with the language of the statute, **§ _.13(b)(1)(i)(B) should be removed from the Final Rule.**

Should § _.13(b)(1)(i)(B) **not** be removed from the Final Rule, we suggest that the following **new criteria** be added to § _.13(b)(2)(ii)(B)(2) in order to prevent the massive rule evasions this exemption currently provides convenient cover for:

> § _.13(b)(2)(ii)(B)(2) Is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, that covered fund, *provided that*:
>
> > *(i) No "hedge" is permitted during the one year following the establishment of the fund.*
> > *(ii) All proceeds from the "hedge" must be paid entirely to the investment advisor, and*
> > *(iii) The "hedge" in the covered fund that does not exceed 3 percent of the total outstanding ownership interests in the fund;*

Suggested criterion § _.13(b)(2)(ii)(B)(2)(i) above is added because in the first year, investment advisors have yet to prove their abilities and must put in their time. Thus, it seems unlikely and

unwarranted that a deferred compensation agreement would require a payout in the first year. Accordingly, no "hedge" should be allowed in the fund's initial year.

Suggested criterion § _.13(b)(2)(ii)(B)(2)(ii) above aims to prevent a situation where a banking entity wishes to retain a larger ownership interest in a covered fund than allowed by the Rule, so it utilizes § _.13(b)(1)(i)(B) to take on an additional ownership interest, but then only pays the investment advisor a small amount of the money that the bank earns on the fund's P&L. Because the NPR merely requires that the risk-mitigating hedge be "directly connected to" the investment advisor's compensation arrangement, and not be in the same amount as the compensation agreement, **there is potential for the banking entity to pocket the majority of the returns on the fund instead of giving them to the investment advisor**. Thus, we feel the Agencies must clarify that in order to qualify for the exemption, **any and all** profits on a risk-mitigating ownership interest must pass to the investment advisor employee whose compensation arrangement is the reason for the "hedge."

Suggested criterion § _.13(b)(2)(ii)(B)(2)(iii) above aims to prevent a situation where a banking entity wishes to retain a larger ownership interest in a covered fund than allowed by the Rule, so it utilizes § _.13(b)(1)(i)(B) to take on an additional ownership interest in an unreasonable amount. Because the NPR makes no qualifications of what "in the same amount" means for a compensation arrangement, a banking entity could take on up to a 100% ownership interest as a "hedge" if it expected the investment advisor employee to double or triple the fund's value that year.

We arrived at 3% as the maximum percentage of ownership interest allowed for the "hedge" based on our understanding of investment advisor compensation arrangements and public information about the amount of seed investments that banking entities intend to make.

Our understanding of investment advisor compensation arrangements is that they often take a form such as this: a banking entity agrees to pay an investment advisor employee a set fee based on a base case expectation of performance, and any performance above the expected performance will be paid outright to the employee.

As a specific example, consider a covered fund organized and offered by a banking entity with $300 million in assets under management. The investment advisor for the fund is an employee of the banking entity. Assume the banking entity sets a base case expectation of a 10% profit for the fund, for which it will pay the investment advisor a $1 million salary. Should the investment advisor employee succeed in leading the fund to a profit that exceeds 10%, the banking entity will pay the employee that excess profit over 10% as follows:

(the % amount in excess of 10% the fund earns) × (the banking entity's "hedge" ownership interest).

To cover such an agreement, the banking entity makes a $10 million[235] "hedge" investment in the covered fund. Should the fund make a 10% profit, the banking entity pays the employee the $1 million demanded by the compensation arrangement. Should the fund instead earn 15%, the banking entity will pay the employee $1 million + (5% × $10 million = $500,000) = $1.5 million. These earnings are ***in addition to*** the up to $9 million[236] the investment advisor employee will earn in carried interest for a 15% profit on the fund that year. The idea that both the carried interest and the risk-mitigating hedging exemptions for covered funds would be required to retain investment advisor employees, as SIFMA argued in a comment letter,[237] seems ludicrous even to us, despite our substantial industry experience and knowledge of the vast compensations that often apply.

Given the arrangements described above, we arrived at 3% as a reasonable figure based on information that *The Wall Street Journal* recently reported: Goldman Sachs has "pooled $600 million from its clients" in order to create a new fund that will provide seed investments to hedge fund managers. The article states that:

> Goldman plans to use the new fund for providing start-up money to hedge fund managers varying from 8 to 10 new hedge funds. Moreover, in each hedge fund Goldman would invest $75 million to $150 million from the new fund created, which in turn, is expected to raise approximately $1 billion in total.[238]

If Goldman expects to be seeding funds that will have $1 billion AUM total, a 3% ownership interest "hedge" would generate $4.5 million (before carried interest; it would be $3.6 million after a 20% fund carried interest fee) should the fund earn a 15% profit in a given year, which would more than provide for the compensation arrangement we describe above.

We have added these suggested new elements to *Annexure B*. Please see Questions 281 and 285 for further discussion.

**<u>Question 285</u>. Is the requirement that an ownership interest in a covered fund may only be used as a hedge (i) by the banking entity when acting as intermediary on behalf of a**

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[235] A $10mm investment will generate a $1 million profit should the fund earn 10% in a given year.

[236] Most hedge funds utilize a 2/20 fee structure, where investors pay a flat 2% fee each year, and then a 20% fee on any profits realized. If a fund with $300 million AUM made a 15% profit ($45 million) in a year, the fund would take 20% of that $45 million, or $9 million total, as a fee.

[237] SIFMA Comment, *supra* note 207, at 5 ("In addition, it is common practice for banking entity employees engaged in the provision of asset management services to have the choice of deferring part of their compensation and having that deferred amount be linked to the performance of the funds in which the employees are involved. The banking entity then 'hedges' that exposure by investing directly in the referenced funds. **These compensation arrangements are critical to the retention of banking entity employees engaged in the provision of asset management services**.") (emphasis added).

[238] Liz Rappaport, *Goldman Focuses on Funding Others*, Wall St. J., Nov. 30 2011, *available at* http://online.wsj.com/article/SB10001424052970203441704577068741666800920.html.

**customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or (ii) to cover compensation arrangements with an employee of the banking entity that directly provides investment advisory or other services to that fund effective? If not, what other requirements would be more effective?**

The hedging exemption provided for employee compensation arrangements, combined with the exemption of carried interest from the definition of ownership, is simply a backdoor to ownership for the bank. The language of § _.13(b)(1)(i)(B) could be interpreted to allow almost any investment in a covered fund as a hedge against compensation.

The notion that taking on an ownership interest in a covered fund would offset the "exposure" the bank has due to the banking employee being compensated with carried interest is shaky at best. Presumably, this "exposure" is to either the risk of a down year where no carried interest is earned by the investment advisor, or the risk of a claw back to previous carried interest earned, or both.

**The banking entity's acquisition of an ownership interest in the covered fund would hardly mitigate this "exposure." Instead, this acquisition would be closer to doubling down.** In up years, the employee or banking entity would receive compensation in the form of carried interest due to its services to the fund **and** due to its ownership interest. In down years, the employee or banking entity would not get paid and the banking entity's investment would **decrease in value.** This is not a hedge that mitigates exposure. Instead, it appears to be a means for banking entities to subvert the intent of the Rule. Thus, the exemption for hedging a compensation arrangement—§ _.13(b)(1)(i)(B)—should be removed.

Additionally, as pointed out in Question 281, the statute only permits hedging if it is directly tied to a **position, contract** or **holding** of a banking entity. Those terms are used in the Proposed Rule to refer to purchases or sales of *tradable assets*. A compensation arrangement is outside the realm of the hedging exemption provided in Section 619(d)(1)(C) of the Act. Thus, § _.13(b)(1)(i)(B) of the Proposed Rule should be removed entirely. A reviewing court shall hold unlawful and set aside agency action, findings, and conclusions found to be in excess of statutory jurisdiction, authority, or limitations, or short of statutory right.[239]

As to the allowance for a bank to hedge while acting as intermediary, we **strongly support** the clarification in § _.13(b)(1)(i)(A) that this is **only** a permitted hedge if the banking entity is acting "on behalf of a customer that is **not itself a banking entity**." We feel the Agencies should further clarify that the bank cannot act as an intermediary if it is facilitating rule evasion on the part of its clients.

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[239] 5 U.S.C. § 706.

Failing to retain this clarification in the Final Rule could lead to tremendous rule evasion, whereby banking entities simply conduct proprietary trading on behalf of each other. For example, assume Goldman Sachs wants to invest in fund X. Morgan Stanley gives Goldman a note tied to the performance of fund X, and Morgan Stanley hedges by taking an ownership interest in that fund. In return, Goldman gives Morgan Stanley a note tied to the performance of fund Y, which Morgan Stanley wants to invest in. Goldman takes an ownership interest in fund Y as a hedge.

While we recognize that "[b]anking entities that have programs that offer notes to customers with returns linked to the performance of an underlying covered fund will need to ensure that any covered fund interests acquired to hedge the customer exposure meet the requirements of this exemption,"[240] such notes must not be engineered in such a way as to promote evasion of any rules on the part of the bank's customer.

Zero-strike call warrants are an example of a rule-evading linked note. Such engineering is praised by the industry, as demonstrated by *Risk Magazine* awarding DBS Bank with the designation of "Regional Derivatives House of the Year" for the bank's "customized investment and hedge services to clients, and [for] providing equity-linked delta-one products linked to Chinese equities via participation notes and zero-strike call warrants linked to China 'A shares.'"[241] We suspect that these "equity-linked" products on Chinese equities may simply allow DBS's investment and hedge fund clients to subvert the rules of the Shanghai and Shenzhen stock exchanges.

China's A-shares are not available to foreign investors unless they are institutional investors "who have been given a Qualified Foreign Institutional Investor (QFII) license quota allocation of allowed investment in these A-shares. Most leading global financial institutions have a QFII quota."[242] Thus, firms like DBS will construct zero-strike call warrants that exactly mimic the P&L of Class A-shares, giving foreign investors their desired exposure to shares they are not legally allowed to own.

Thus, to avoid the same sort of financial engineering for the sake of rule evasion using § _.13(b)(1)(i)(A), the Agencies should not permit a banking entity to hedge when it is acting as intermediary to a customer that is not itself eligible to invest in the covered fund.

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[240] Sullivan & Cromwell LLP, Agencies Release Proposed Rule Implementing the Volcker Rule 30. n.75 (Oct. 12, 2011), http://www.sullcrom.com/files/Publication/32eff455-84c8-4a1e-a8e7-11917fa29e7b/Presentation/PublicationAttachment/ce164276-f26c-43ea-aa6a-14509940df0f/SC Publication Volcker Rule 10-12-11.pdf.

[241] *Regional Derivatives House of the Year: DBS*, Risk Magazine, Oct. 21 2011, *available at* http://www.risk.net/asia-risk/feature/2119187/regional-derivatives-house-dbs.

[242] Seeking Alpha, *China A-Shares ETFs: 2 Alternatives to PEK*, (Apr. 5, 2011). http://seekingalpha.com/article/261796-china-a-shares-etfs-2-alternatives-to-pek.

**Question 287. Is the requirement that the hedging transaction involve a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest 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 other level of correlation be required? Should the proposal specify in greater detail how correlation should be measured? If not, how could it better do so?**

We do not feel that the requirement that the hedging transaction involve a substantially similar offsetting exposure to the same covered fund is effective in the case of compensation arrangements. For a discussion of why it is not effective, see Questions 281 and 285.

For our suggested amendments to make the requirement effective, see Question 284 and *Annexure B*.

**Question 288. Is the requirement that the transaction not give rise, at the inception of the hedge, to material risks that are not themselves hedged in a contemporaneous transaction effective? Is the proposed materiality qualifier appropriate and sufficiently clear? If not, what alternative would be effective and/or clearer?**

Assuming that the allowance in § _.13(b)(1)(i)(B) is kept, we suggest that the language be changed in § _.13(b)(2)(ii)(C) from "at the inception of" to "throughout the lifespan of."

**Question 289. Is the requirement that any transaction conducted in reliance on the hedging exemption be subject to continuing review, monitoring and management after the transaction is established effective? If not, what alternative would be more effective?**

The requirement is not effective unless the language of § _.13(b)(2)(ii)(C) is changed from "at the inception of" to "throughout the lifespan of."

**Question 290. Is the proposed documentation requirement effective? If not, what alternative would be more effective? What burden would the proposed documentation requirement place on covered banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?**

For further discussion, please see Question 283.

**Question 291. Is the proposed rule's implementation of the "foreign funds" exemption effective? If not, what alternative would be more effective and/or clearer?**

We strongly support the current definition of "foreign funds," and find the implementation of the exemption for true foreign funds to be effective.

We feel that the current definition will prevent considerable evasion of the Rule that could otherwise be achieved through offshore operations or operating out of non-U.S. subsidiaries. It is very important to limit the foreign funds exemption to only activities that truly happen outside of the U.S., with no executions occurring in the U.S., no U.S. resident being involved in the transaction, and no party to the transaction being a resident of the U.S.

While we recognize that there has been considerable pressure on the Agencies (to date, we have read comment letters from banks in Canada and Japan expressing their distaste for the current implementation), we feel that the current implementation of the foreign funds exemption matches the statute, and to dilute the implementation in any way would be to break with the very clear language of the statute. Thus, we urge the Agencies to retain the current clearly defined exemption for "foreign funds" in the Final Rule. We also urge the Agencies to be vigilant in their enforcement, as the banking entities have previously and likely will continue to try to use offshore or shadow corporations, subsidiaries or affiliates to avoid regulation.

**Question 293. Are the proposed rule's provisions regarding when a transaction or activity will be considered to have occurred solely outside the United States effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should additional requirements be added? If so, what requirements and why? Should additional requirements be modified or removed? If so, what requirements and why or how?**

We support the current provisions that determine when a transaction or activity has occurred solely outside the U.S. None of the requirements should be modified or removed. It is crucial that any foreign activity exempted from Volcker be truly outside the borders of the United States.

The provisions of § _.13(c)(3)(i) prevent U.S. banks with foreign operations and subsidiaries from evading the Rule using the foreign funds exemption. The provisions of § _.13(c)(3)(ii) ensure that foreign banks with substantial U.S. operations must comply with Volcker, and thus do not enjoy a competitive advantage over U.S.-domiciled banks. Failure to retain § _.13(c)(3)(ii) may drive U.S. banks to move their operations entirely abroad. Moreover, § _.13(c)(3)(iii) ensures that U.S.-based institutional cannot simply move all of their investments into foreign funds that need not adhere to the restrictions of Volcker. Failure to retain § _.13(c)(3)(iii) in the Final Rule could lead to a flight of (U.S.-resident owned) capital from the United States, and thus threaten economic growth and the financial stability of the United States.

We do ask that the Final Rule be clarified to more carefully define the terms used in the foreign fund criteria—§ _.13(c)(1), § _.13(c)(2) and § _.13(c)(3)—so as to eschew evasion based on mincing of words.

**Question 294. Is the proposed exemption consistent with the purpose of the statute? Is the proposed exemption consistent with respect to national treatment for foreign banking**

**organizations? Is the proposed exemption consistent with the concept of competitive equity?**

The proposed exemption is absolutely consistent with the purpose of the statute, and as outlined in Question 293, is crucial for competitive equity to continue for U.S.-domiciled businesses.

**Question 295. Does the proposed rule effectively define a resident of the United States for these purposes? If not, how should the definition be altered? What definitions of resident of the United States are currently used by banking entities? Would using any one of these definitions reduce the burden of complying with section 13 of the BHC Act? Why or why not?**

We support the current definition of a U.S. Resident.

**Question 296. Is the proposed rule's implementation of the statute's "sale and securitization of loans" rule of construction effective? If not, what alternative would be more effective and/or clearer?**

We support the restrictions of § _.13(d)(1) that limit the holdings of Volcker-exempted issuers of asset-backed securities to loans, as we feel it is effective and true to statutory language and intent. We feel it is important to strictly define what is permitted in any loan securitization allowed by the NPR. To that end, we have serious concerns with § _.13(d)(2), as we feel it is vague enough to allow products that overstep Congressional intent. We also have concerns with § _.13(d)(3), which we have discussed below in our answer to Question 299.

Our concern with § _.13(d)(2) and § _.14(a) is the language "contractual rights or assets directly arising from those loans supporting the asset-backed securities."

The statute only allows for the sale and securitization of loans and thus the Proposed Rule should only allow for the sale of loans and loan securitizations. The language of § .13(d)(2) goes beyond the statutory intent. "Contractual rights or assets directly arising from those loans" could mean ABS, RMBS, CDS, or any other product, making what is allowed by these exemptions far and above what was directed by the statute. For instance, this language would create a blanket exemption for a hybrid-synthetic securitization whereby an SPV issues securities backed by certain loans and credit default swaps tied to those loans. Such credit default swaps would qualify as contracts arising from loans.

A review of the Congressional Record reveals that Congress did not intend the securitization rule of construction to include loans that "become financial instruments traded to capture the change in their market value."[243] Thus, in order to remain true to the statute, the Final Rule should

[243] 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

remove § _.13(d)(2) and § _.14(a)(2)(v)(B). A reviewing court shall hold unlawful and set aside agency action, findings, and conclusions found to be in excess of statutory jurisdiction, authority, or limitations, or short of statutory right.[244]

If § _.13(d)(2) and § _.14(a)(2)(v)(B) are not removed, they must at a minimum be made more explicit, making it clear that credit default swaps, total return swaps and any form of repos are specifically excluded from the exemption for loan securitizations.

**Question 299. Are the proposed rule and this Supplementary Information sufficiently clear regarding which derivatives would be allowed in a "securitization of loans" under § _.13(d)(3) of the proposed rule? Is additional guidance necessary with respect to the types of derivatives that would be included in or excluded from a securitization of loans for purposes of interpreting the rule of construction contained in section 13(g)(2) of the BHC Act? If so, what topics should the additional guidance discuss and why?**

The statutory rule of construction at § _.13(g)(2) of the BHC Act only allow for the securitization of "loans." The Agencies have exceeded their statutory authorization in proposing to include interest rate or foreign exchange derivatives as acceptable components of "loan" securitizations. In issuing implementing regulations, an administrative agency must give effect to the unambiguously expressed intent of Congress.[245]

We are cognizant of the fact that securitizations, total rate of return swaps and other structured finance machinations currently utilize interest rate or foreign exchange derivatives as embedded components. Nevertheless, nothing in the Congressional Record demonstrates that the securitization exemption was meant to include such derivatives as well. Simply put, interest rate, foreign exchange, and other derivatives are not loans. To paraphrase Gertrude Stein, a loan is a loan is a loan.

Congress had good reason to circumscribe the universe of exempted securitizations to those based just on "loans." The asset-backed securities ("ABS") market played a significant, pernicious role in the liquidity crisis of 2008.[246] The ensuing collapse affected global markets, both financial and non-financial, and cost American families and businesses over $13 trillion in wealth and 5.5 million jobs.[247] ABS had the effect of agglomerating risks from trillions of dollars of receivables (whether directly-held or in "notional amount"), and in many instances, those risks

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[244] 5 U.S.C. § 706.
[245] *Chevron*, 467 U.S. at 842-43.
[246] Josh Clark. *How Can Mortgage-backed Securities Bring Down the U.S. Economy?*. howstuffworks, http://money.howstuffworks.com/mortgage-backed-security.htm (last visited Nov. 7, 2011).
[247] Phillip Swagel, *The Cost of the Financial Crisis: The Impact of the September 2008 Economic Collapse*. Pew Economic Policy Group, Apr. 28, 2010, http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/Cost-of-the-Crisis-final.pdf?n=6727 (last visited Nov. 9, 2011).

were not well understood or properly priced. Extending the purview of exempted securitizations under the Volcker Rule would only serve to increase the chances of similar economic destruction reoccurring.

At footnote 309 the Proposed Rule states that

> [t]he types of derivatives permitted under § _.13(d)(3) of the Proposed Rule are not meant to include a synthetic securitization or a securitization of derivatives, but rather to include those derivatives that are used to hedge foreign exchange or interest rate risk resulting from loans held by the issuer of asset-backed securities.

However, the Agencies should note that a hedging exemption already exists under the Volcker Rule, which allows bona fide, risk-mitigating hedging transactions. Thus, there is no need for a separate carve-out for interest rate or foreign exchange derivatives, even assuming there were statutory authorization for such a carve-out (which there is not).

**Question 300. Should derivatives other than interest rate or foreign exchange derivatives be allowed in a "securitization of loans" for purposes of interpreting the rule of construction contained in section 13(g)(2) of the BHC Act? Why or why not? What would be the legal and economic impact of not allowing the use of derivatives other than interest rate or foreign exchange derivatives in a "securitization of loans" under § _.13(d)(3) of the proposed rule for existing issuers of asset-backed securities and for future issuers of asset-backed securities?**

For the reasons described above, other derivatives besides interest rate or foreign exchange derivatives should also not be allowed under the rubric of "securitization of loans." In fact, the Agencies should explicitly state in the language of the Proposed Rule that credit derivatives may not play a component role in any exempted securitization under § _.13(d). The Supplementary Information suggests that such is the case, but the regulatory language tells another story, as discussed in Question 256.

**Question 301. Should the Agencies consider providing additional guidance for when a transaction with intermediate steps constitutes one or more securitization transactions that each would be subject to the rule? For example, both auto lease securitizations and asset-backed commercial paper conduits typically involve intermediate securitizations. The asset-backed securities issued to investors in such covered funds are technically supported by the intermediate asset-backed securities. Should these kinds of securitizations be viewed as a single transaction and included within a securitization of loans for purposes of the proposed rule? Should each step be viewed as a separate securitization?**

Each step in a multi-step securitization should be viewed as a separate securitization, to ensure that the Volcker Rule's specific restrictions are upheld in each intermediate level of

securitization. Otherwise, if these securitizations are viewed as a single transaction, one component securitization could include CDS or other prohibited derivatives without being subject to the Rule, especially where those prohibited derivatives play no direct role in the final, above-board securitization. Securities issued via multi-step securitizations are impermissibly risky assets that can hide their underlying dangers under layers of structured complexity.

**Question 302. Is the proposed rule's implementation of exemptions for covered fund activities and investments pursuant to section 13(d)(1)(J) of the BHC Act effective? If not, what alternative would be more effective and/or clearer?**

Please see our answer to Question 303.

**Question 303. Is the proposed rule's approach to utilizing section 13(d)(1)(J) of the BHC Act to permit a banking entity to acquire or retain an ownership interest in, or act as sponsor to, certain entities that would fall into the definition of covered fund effective? Why or why not? If not, what alternative would be more effective and why? What legal authority under the statute would permit such an alternative?**

We do not believe that the approach to utilizing Section 13(d)(1)(J) to permit banking entities to retain an ownership interest in, or act as sponsor to bank owned life insurance is appropriate because, as we discuss in our answer to Question 305, we do not feel that bank owned life insurance promotes what is required to qualify for an exemption under Section 13(d)(1)(J). Further, because the activity described in § _.14(a)(1) does not promote the safety and soundness of banking entities or the financial stability of the United States, there is no authority for it to be a permitted activity, and thus it should be removed from the Final Rule.

We also believe that the exemption for "contractual rights or assets directly arising from those loans supporting the asset-backed securities," as described in § _.14(a)(2)(v)(B), is vague enough to allow for products like credit default swaps, total return swaps and any form of repos to be considered permitted. As we discussed in Question 30, total return swaps and repos pose risk to the financial stability of the United States. As for credit default swaps, the Congressional Record makes clear that CDSs are considered to be a high-risk, proprietary trading activity that should not be allowed in the Final Rule.[248]

The statute only allows for the sale and securitization of loans and thus the Proposed Rule should only allow for the sale of loans and loan securitizations. "Contractual rights or assets directly arising from those loans" could mean ABS, RMBS, CDS, or any other product, making what is

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[248] 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("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' or 'market-making-related.'").

allowed by these exemptions far and above what was directed by the statute. For instance, this language would create a blanket exemption for a hybrid-synthetic securitization whereby an SPV issues securities backed by certain loans and credit default swaps tied to those loans. Such credit default swaps would qualify as contracts arising from loans. A review of the Congressional Record reveals that Congress did not intend the securitization rule of construction to include loans that "become financial instruments traded to capture the change in their market value."[249]

Thus, we ask the Agencies to either remove § _.14(a)(2)(v)(B) or to make it more explicit, clarifying that credit default swaps, total return swaps and any form of repos are specifically excluded from the exemption for loan securitizations.

**Question 305. Do the exemptions provided for in § _.14 of the proposed rule effectively promote and protect the safety and soundness of banking entities and the financial stability of the United States? If not, why not?**

We do not believe that the exemption for bank owned life insurance in § _.14(a)(1) protects the safety and soundness of the banking entities. Past class action lawsuits settlements, such as *Atkinson v. Wal-Mart Stores, Inc.*, wherein Walmart settled for over $2 million in December 2011[250] over its corporate owned life insurance policies, demonstrate that there is substantial risk of litigation.

In addition, bank owned life insurance can pose a liquidity risk to the bank. As the OCC warned in its "Interagency Statement on the Purchase and Risk Management of Life Insurance":

> Before purchasing permanent insurance, management should recognize the **illiquid nature of the product** and ensure that the institution has the long-term financial flexibility to hold the asset in accordance with its expected use.[251]

The OCC also warned that "[w]hile BOLI can be a useful product to recover costs associated with providing employee benefits, the Agencies are concerned that some institutions have invested a significant amount of capital in BOLI without an adequate understanding of the full

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[249] *Id.*

[250] *Atkinson v. Wal-Mart Stores, Inc.*, 2011 U.S. Dist. LEXIS 150274 (M.D. Fl. 2011). *available at* http://www.leagle.com/xmlResult.aspx?xmldoc=In%20FDCO%2020111229A69.xml&docbase=CSLWAR3-2007-CURR.

[251] Interagency Statement on the Purchase and Risk Management of Life Insurance, OCC Bulletin No. 2004-56 (Dec. 7. 2004); FDIC FIL-127-2004 (Dec. 7, 2004); Federal Reserve Board SR Letter No. 04-19 (Dec. 7, 2004); OTS TB 84 (Dec. 14. 2004), *available at* http://www.occ.treas.gov/news-issuances/bulletins/2004/bulletin-2004-56a.pdf.

array of risks it poses."[252] Permitting bank owned life insurance ("BOLI") exposes the banking entities to potential litigation risk from the insured's heirs.

Finally, we find it to be an insult to the inhabitants of this country that banking entities would be given a blanket exemption for bank owned life insurance under the pretense of protecting the safety and soundness of banking entities and the financial stability of the United States. Bank owned life insurance has been shown to contain "dead peasant" policies[253] that reward banks when an employee dies. And if certain steps are taken, "the death benefit proceeds can be received income tax free."[254] While "dead peasant" policies may perhaps benefit the bottom line of the banking entity, they do so at the expense of the safety and soundness of their employees, which is both morally and practically untenable.

Thus, we suggest that the Agencies remove the exemption for bank owned life insurance, as it does **not** promote the safety and soundness of banking entities or the financial stability of the United States.

While we support the restrictions of § _.14(a), we feel that the vague language of § _.14(a)(2)(v)(B) needs to be clarified, as we suggest in our answer to Question 305. As written, we do not believe that § _.14(a)(2)(v)(B) protects the financial stability of the United States. However, we do feel that the restrictions outlined in § _.14(a)(2)(v)(A) and (C) are well-worded and thorough, and should be preserved.

**Question 306. Are the proposed rule's provisions regarding what qualifications must be satisfied in order to qualify for an exemption under § _.14 of the proposed rule effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should additional requirements be added? If so, what requirements and why? Should additional requirements be modified or removed? If so, what requirements and why or how?**

For further discussion, please see Question 256.

**Question 307. Does the proposed rule effectively cover the scope of covered funds activities which the Agencies should specifically determine to be permissible under section 13(d)(1)(J) of the BHC Act? If not, what activity or activities should be permitted? For additional activities that should be permitted, on what grounds would these activities**

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[252] News Release, OCC, Bank-Owned Life Insurance (Dec. 7, 2004), *available at* http://www.occ.treas.gov/news-issuances/bulletins/2004/bulletin-2004-56.html.

[253] *See* Ashby Jones, *Dead Peasant' Policies: The Next Big Thing in Insurance Litigation*, Wall St. J., Feb. 24._2009, http://blogs.wsj.com/law/2009/02/24/dead-peasant-policies-the-next-big-thing-in-insurance-litigation.

[254] Denise Desautels. *Employer-owned Life Insurance: The Rules Have Changed*, Life Health Pro. July 1, 2011, *available at* http://www.lifehealthpro.com/2011/07/01/employerowned-life-insurance-the-rules-have-change.

**promote and protect the safety and soundness of banking entities and the financial stability of the United States?**

The NPR has used Section 13(d)(1)(J) of the BHC Act to create an excessive number of permissible activities that do not clearly promote the safety and soundness of the banking entities, and may even detract from their safety and soundness. We remind the Agencies that, as per Congressional intent, Section 13(d)(1)(J) "sets an extremely high bar."[255]

We do not support the addition of any new activities. The current allowances are already over-inclusive. The Agencies should not create even more loopholes for the banking entities to use to subvert the Rule. Banking entities in recent history have proven to be extraordinarily adroit at engineering their way around regulation.[256]

The inclusion of any additional permitted activities lobbied for by the financial lobby during the comment period would be an unfortunate acquiescence, as the public would not have the opportunity to comment on the potential dangers of such additional exemptions.

**Question 309. Rather than permitting the acquisition or retentions of an ownership interest in, or acting as sponsor to, specific covered funds under section 13(d)(1)(J) of the BHC Act, should the Agencies use the authority provided under section 13(d)(1)(J) to permit investments in a covered fund that display certain characteristics? If so, what characteristics should the Agencies consider? How would investments with such characteristics promote and protect the safety and soundness of the banking entity and promote the financial stability of the United States?**

We do not support replacing the current framework for permitted ownership interests with the blanket ability to permit investments in any covered fund that displays certain characteristics. Allowing investments in funds that "display certain characteristics" would almost certainly lead to the banking entities using all the legal, sales and structuring resources available to them in order to offer and organize funds, or work with their peers in the market to create, funds that matched whatever characteristics the Agencies may outline. This risk of financial engineering with intent to subvert the Rule already exists with the current permitted ownerships. It would not be conducive to an effective Final Rule to create additional avenues for covered fund investments.

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[255] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[256] *See* Gerald Epstein, The Volcker Rule: Addressing Systemic Risk (Nov. 9. 2011), *available at* http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2011/11/AFR-Volcker-Conference-Gerald-Epstein-PP-11-9-11.pdf (citing John D. Finnerty & Douglas R. Emery, *Corporate Securities Innovation: An Update*. Journal of Applied Finance, Spring/Summer 2002)). Epstein points out that of the 80 new corporate securities that Finnerty and Emergy reviewed for their paper, a total of 25 or 31% of these product innovations were motivated by tax or regulatory reasons.

**<u>Question 310</u>. Should venture capital funds be excluded from the definition of "covered fund"? Why or why not? If so, should the definition contained in rule 203(l)-1 under the Advisers Act be used? Should any modification to that definition of venture capital fund be made? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?**

Venture capital funds should not be excluded from the definition of "covered fund." While venture capital is sometimes responsible for supplying needed capital that can create lasting businesses, very few venture-backed companies actually make it to a merger, and even fewer make it to the IPO stage. As Fred Wilson, partner at Union Square Ventures, noted: "Based on the NVCA statistics on the venture capital industry, there are on average 1,000 early stage financings every year."[257] Of that, "1–3% get to an IPO and 5–10% get to an M&A exit over $100mm. So 85–95% of all venture backed startups will either fail or exit below $100mm."[258] Venture capital funds are inherently risky, as the assumption is that the majority of the investments will either fail outright, or exit for less than $100 million. Thus, it would not be in the interest of the safety and soundness of the banking entities, or in the interest of the financial stability of the United States, to create a blanket exemption for venture capital funds.

The Agencies should consider the possibility that a blanket exemption allowing banking entities to take ownership interests in venture capital funds could lead to evasion of the Rule.

While we note that the SEC, in rule 203(l)-1 under the Advisers Act, sought "to distinguish venture capital funds from other types of private funds, such as hedge funds and private equity funds, and to address concerns expressed by Congress regarding the potential for systemic risk,"[259] we feel that the Agencies should not underestimate the ability of the banking entities to structure new entities that fall within the law but subvert its intent.

If the Agencies jointly insist, despite our objections, to exempt venture capital funds, we do believe that relying on Rule 203(l)-1 of the Advisers Act, given its restrictions, would somewhat limit the potential for evasion. Because Rule 203(l)-1 under the Advisers Act requires that "venture capital funds" may not hold more than 20% of the fund in non-qualifying

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[257] A VC. *There Aren't Many Exits Over $100mm*, June 22. 2011. http://www.avc.com/a_vc/2011/06/there-arent-many-exits-over-100mm.html.

[258] A VC. *There Aren't Many Venture Backed IPOs*, June 23. 2011. http://www.avc.com/a_vc/2011/06/there-arent-many-venture-baced-ipos.html.

[259] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers. Investment Advisers Act Release No. 3222, 76 Fed. Reg. 39.646, 39.648 (July 6. 2011) (to be codifed at 17 C.F.R. §§ 275.202(a)(30)-1. 275.203(l)-1. (m)-1). *available at* http://www.sec.gov/rules/final/2011/ia-3222.pdf.

investments,[260] where "qualifying investments"[261] must consist of "equity securities," the potential for Volcker Rule-subversion would mostly be limited to proprietary trading in those asset classes. However, "equity securities," as defined in section 3(a)(11) of the Securities Exchange Act of 1934,[262] include many products that are used in proprietary trading, including stock, warrants and convertible securities (including convertible debt).[263] Additionally, the 20% allowance for venture capital funds to invest in non-qualifying investments would seem to allow a banking entity to work with a complicit venture capital fund (or its own venture capital fund) to practice rule-evading proprietary trading with a wide variety of asset types, and still be in compliance with the Advisers Act and the Proposed Rule.

Thus, in order to prevent interests in hedge funds or private equity funds from being structured as venture capital funds and thereby circumventing the Proposed Rule, as well as to prevent banking entities from investing in yet another highly risky asset class, we **strongly oppose** excluding venture capital funds from the definition of "covered fund."

**Question 311. Should non-U.S. funds or entities be included in the definition of "covered fund"? Should any non-U.S. funds or entities be excluded from this definition? Why or why not? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?**

We believe that the NPR as written is correct, thorough, and promotes the safety and soundness of the banking entities and the financial stability of the United States, and should not be changed. We support the language of § _.13(c)(1)(iii) that insists that foreign funds are only exempt from the definition of covered fund as long as, among other important restrictions outlined in § _.13(c), "[n]o ownership interest in such covered fund is offered for sale or sold to a resident of the United States." We also support the other restrictions provided in § _.13(c), and feel all subsections of § _.13(c) must be retained in the Final Rule. We believe that if the restrictions outlined in § _.13(c) are diminished, banking entities would have a substantial incentive to move

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[260] *Id.* (proposing 17 C.F.R. § 275.203(l)-1(a)(2) (2012), which partly defines a venture capital fund as one holding "no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments").

[261] *Id.* (proposing 17 C.F.R. § 275.203(l)-1(c)(3), which states that "[q]ualifying investment means: (i) An equity security issued by a qualifying portfolio company that has been acquired directly by the private fund from the qualifying portfolio company; (ii) Any equity security issued by a qualifying portfolio company in exchange for an equity security issued by the qualifying portfolio company described in paragraph (c)(3)(i) of this section; or (iii) Any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, as defined in section 2(a)(24) of the Investment Company Act of 1940 (15 U.S.C. § 80a-2(a)(24)), or a predecessor, and is acquired by the private fund in exchange for an equity security described in paragraph (c)(3)(i) or (c)(3)(ii) of this section.").

[262] 15 U.S.C. § 78c(a)(11) (2011).

[263] *See* Asher B. Bearman, Steven R. Yentzer, Howard S. Rosenblum, & Andrew D. Ledbetter, DLA Piper, *SEC Proposes Definition of "Venture Capital Fund" for Exemption from Advisers Act* (Nov. 23, 2010), *available at* http://www.dlapiper.com/sec-proposes-definition-of-venture-capital-fund-for-exemption-from-advisers-act.

all of their hedge funds and their affiliates offshore in order to be unencumbered by the NPR. We do **not** believe that there are any non-U.S. funds or entities that should be excluded from the definition of "covered fund," and any such allowances would dilute the effectiveness and enforceability of the Rule.

**Question 312. Should so-called "loan funds" that invest principally in loans and not equity be excluded from the definition of "covered fund"? Why or why not? What characteristics would be most effective in determining whether a fund invests principally in loans and not equity? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?**

We do not support an exclusion of "loan funds" from the definition of "covered funds" as we believe it would provide an opportunity for rule evasion.

**Question 313. Are the proposed rule's proposed determinations that the specified covered funds activities or investments promote and protect the safety and soundness of banking entities and the financial stability of the United States appropriate? If not, how should the determinations be amended or altered?**

We do not believe that the exemption for bank owned life insurance in § _.14(a)(1) protects the safety and soundness of the banking entities or the financial stability of the United States. We also have concerns that this is the case for § _.14(a)(2)(v)(B). Please see answers to Questions 303 and 305 for a complete discussion.

**Question 314. Is the proposed rule's approach to implementing the limitations on certain transactions with a covered fund effective? If not, what alternative approach would be more effective and why?**

The language of § _.16(a)(2)(ii)(C) is directly at odds with the statute. In fact, it seems to have taken the language of the statute and inverted it entirely.

Section 619(f)(3)(A)(iii) of the statute instructs that the Board may permit a banking entity to enter into a prime brokerage transaction with a covered fund if:

> The Board **has determined** that such transaction is consistent with the safe and sound operation and condition of the banking entity.

The Proposed Rule reverses the logic and intent of the statute, stating instead that a banking entity may enter into a prime brokerage transaction with a covered fund if:

> The Board **has *not* determined** that such transaction is inconsistent with the safe and sound operation and condition of the covered banking entity.[264]

Instead of forbidding a banking entity from entering into prime brokerage transactions with a covered fund *unless the Board has determined the transaction is allowed*, the Proposed Rule does the opposite: it explicitly **permits** prime brokerage transactions as long as the Board has **not** determined the transaction is disallowed. The statute suggests that a bank can only conduct prime brokerage if granted an exemption on a transaction-by-transaction basis. The Proposed Rule defies the statute and creates a presumption of permissibility.

Because the language of § _.16(a)(2)(ii)(C) is at odds with the statute, it must be amended to match the original language in Section 619(f)(3)(A)(iii) of the statute. A reviewing court shall hold unlawful and set aside agency action, findings, and conclusions found to be in excess of statutory jurisdiction, authority, or limitations, or short of statutory right.[265]

We also feel that there should be a fourth criteria added to § _.16(a)(2)(ii) that requires that a banking entity has reduced its ownership in a fund to 3% before any prime brokerage transactions can occur between the banking entity and the covered fund. In other words, if a bank is both a seed investor (within the first year) and the prime broker of a fund, it should NOT be able to finance that fund or provide other prime brokerage services until after the seeding period is over.

If banking entities are allowed to act as prime broker to covered funds within the one year seed period (or during the additional two years if they are granted an extension), this could pose systemic risk. The bank can, in the seed period, be invested in up to 100% of the fund, subject to a maximum of 3% of the bank's Tier 1 capital. If the Agencies leave the NPR as written (i.e., not incorporating our suggestion to remove "financing" from the definition of prime brokerage transaction, as suggested in Question 241), the Bank could provide financing to the fund, allowing it to leverage up. A subsequent reduction in the fund's value would compel the bank to act to bail the fund out, as it would have a massive investment in the fund.

Please see our suggested addition, § _.16(a)(2)(ii)(D), in *Annexure B*.

**<u>Question 315</u>. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?**

As stated in Question 314, § _.16(a)(2)(ii)(C) must be amended to match the original language in Section 619(f)(3)(A)(iii) of the Act.

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[264] Proposed Rule § _.16(a)(2)(ii)(C).
[265] 5 U.S.C. § 706.

**Question 317. Should the Agencies provide a different definition of "prime brokerage transaction" under the proposed rule? If so, what definition would be appropriate? Are there any transactions that should be included in the definition of "prime brokerage transaction"? Are there transactions or practices provided by banking entities that should be excluded in order to mitigate the burdens of complying with section 13 of the BHC Act?**

As outlined in our answer to Question 241, the Agencies should remove "financing" and "securities borrowing or lending services" from the definition of "prime brokerage transaction." We have added our suggested changes to the definition to *Annexure B*.

We further feel that a banking entity should not be allowed to act as a prime broker for a covered fund that the bank offers and organizes. However, since this is expressly permitted by the statute, we suggest instead that a banking entity be required to reduce its ownership interest to the 3% de minimis limit before it is allowed to act as prime broker to the covered fund.

**Question 318. With respect to the CEO (or equivalent officer) certification required under section 13(f)(3)(A)(ii) of the BHC Act and § _.16(a)(2)(ii)(B) of the proposed rule, 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)?**

For further discussion, please see Question 346.

**Question 319. Is the proposed rule's inclusion of a compliance program requirement effective in light of the purpose and language of the statute? If not, what alternative would be more effective?**

We find the NPR's inclusion of a compliance program requirement to be both effective and consistent with the Rulemaking directive in the Anti-Evasion section of the BHC Act, Section 13(e)(1), which insists that the Agencies must issue "regulations, as part of the rulemaking provided for in subsection (b)(2), regarding internal controls and recordkeeping, in order to insure compliance with this section."

**Question 321. What implementation, operational, or other burdens or expenses might be associated with the compliance program requirement? How could those burdens or expenses be reduced or eliminated in a manner consistent with the purpose and language of the statute?**

For further discussion, please see Questions 345 and 174.

**Question 323. Are the six proposed elements of a required compliance program effective? If not, what alternative would be more effective? Should elements be added or removed? If so, which ones and why?**

The proposed elements are generally effective and should all be retained in the Final Rule. Failing to retain these provisions, in our opinion, would make evasion of the rule substantially easier. We have suggested improvements on § _.20(b)(1), § _.20(b)(4) and § _.20(b)(6), outlined below.

The first proposed element requires "internal written policies and procedures reasonably designed"[266] to ensure compliance with the Rule. We feel that this element could be further strengthened by linking it to the "reasonable assurance" and "reasonableness" language already present in Sarbanes-Oxley.[267]

We support the fourth proposed element, independent testing. However, we have concerns with both approaches allowed by this element, and thus ask the Agencies to vigilantly monitor both approaches. We feel testing by qualified banking entity personnel will be most effective if performed by banking entities' Internal Audit personnel. These employees, usually respected (and appropriately feared) within a banking entity, have the auditing expertise, internal authority, and institutional knowledge required to conduct effective testing. Since the NPR does not provide clear monetary penalties, we are concerned that internal audit teams may lack the usual incentive (avoiding substantial loss to the firm from monetary sanctions) that ensures zealous enforcement of other regulatory provisions. Additionally, we have concerns about allowing a qualified outside party to conduct the testing. While outside parties may more scrupulously measure a firm, they also are at a considerable disadvantage in understanding the inner workings of the firm (e.g., how its accounts are structured, the specifics of its technological platforms, and the specific responsibilities of each internal unit). Thus, regardless of which approach a banking entity takes to comply with § _.20(b)(4), we ask that the Agencies remain vigilant and ensure that the implementation of any testing is adequate.

The sixth proposed element, recordkeeping,[268] is not effective as currently written, because it only requires the retention of records for "no less than 5 years." The statute of limitations on civil suits for Fraud, Contracts and Collection of Debt on Accounts in New York State is **six** years,[269] and because so many of the major banking entities have significant presence in New York, the Agencies should ensure that the minimum record retention matches the six-year statute of limitations. We have added this suggested change to *Annexure B*.

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[266] Proposed Rule § _.20(b)(1).
[267] *See* Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934. 72 Fed. Reg. 35,324. 35,324 (June 27. 2007) (codified at 17 C.F.R. pt. 241 (2008)).
[268] Proposed Rule § _.20(b)(6).
[269] N.Y. Civ. Prac. L. & R. § 213.

**Question 324. For each of the six proposed elements of a required compliance program for which minimum standards are provided in proposed Appendix C, are the proposed minimum standards effective? If not, what alternative would be more effective? Should minimum standards be added or removed? If so, which ones and why?**

We support the six proposed elements and feel it is crucial that none of the minimum standards be removed.

We do suggest, however, that element VII, Record Keeping, be amended to 6 years, so that it matches the New York State Statute of Limitations for Civil Suits on Contracts and Fraud.[270] We also suggest that the language of element III, Internal Controls[271] be modified to require "immediate notification" rather than "timely notification," as discussed in Question 325.

**Question 325. Does the requirement that a banking entity provide timely notification to the relevant Agency provide sufficient guidance as to what activities must be reported and how and when such reporting should be made? Should more specific standards be provided (e.g., regarding the timing of reporting and the types of activities that must be reported)? If so, what additional criteria should be implemented? Should the notification requirement be applied explicitly to banking entities that are not required to comply with the minimum standards specified in Appendix C because they are below the thresholds specified in § _.20(c)(2)? Why or why not?**

"Timely notification" is far too vague a guideline for meaningful implementation. Appendix C, element III notes in "Analysis and quantitative measurements" a series of minimum criteria that must be present. One of those criteria states that when any quantitative measurement raises a concern regarding compliance with section 13 of the BHC Act, there should be both an immediate internal review and escalation, and "timely notification to [Agency]."[272]

We feel that "timely" here is insufficiently clear, and that the language of the rule should require that the banking entity instead **immediately notify the [Agency]**. Even clearer would be language requiring that such notification should not occur any later than one day after the concern is raised internally.

It should not be unduly burdensome for all banking entities—regardless of their required level of compliance—to immediately report any concerns found internally to the appropriate Agency. As long as the banking entity is complying with the rules, this should be a rare occurrence.

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[270] *Id.*
[271] NPR at 68.966.
[272] *Id.*

**Question 326. Are there specific records that banking entities should be required to make and keep to document compliance with section 13 of the BHC Act and the proposed rule? Please explain.**

Records must be kept on *all* hedges conducted by covered banking entities. These records will ensure that the specific hedging is appropriate and not simply a vehicle used to make proprietary trades under the cover of hedging exemptions. We have provided a number of clarifications and additions to the required reporting for risk-mitigating hedging transactions in our answer to Question 114.

In addition to the metrics and quantitative measurements required for reporting, any time a "quantitative measurement raises any question regarding compliance,"[273] the banking entity should document the occurrence, the cause for concern, and the date and time of detection. This will allow for the Agencies to ensure that, as required, they are notified of the concern in a "timely" way.[274]

Additionally, as stated in Question 323, the period of time that records must be held should be extended to ***six years*** to match the statute of limitation for Contracts in the state of New York.

**Question 328. Should the proposed rule permit banking entities to comply with Appendix C of the proposed rule on an enterprise-wide basis? If so, why? What are the advantages and disadvantages of an enterprise-wide compliance program? Should the proposed appendix provide additional clarity or discretion regarding how such an enterprise-wide program should be structured? If so, how? Please include a discussion relating to the infrastructure of an enterprise-wide compliance program and its management. If enterprise-wide compliance or similar programs are used in other contexts, please describe your experience with such programs and how those experiences influence your judgment concerning whether or not you would choose an enterprise-wide compliance program in this context.**

We feel that an enterprise-wide compliance program will only be effective in combination with *additional* programs at the trading unit or subsidiary level. Appendix C's element VI (Training) is particularly well suited to an enterprise-wide program. The Internal Policies and Procedures (II) and Record Keeping (VII) elements are also good candidates for enterprise-wide programs, since all divisions of the banking entity will need to both take records and know what steps to take at a high level to ensure compliance.

In our collective experience working at banking entities, the most successful enterprise-wide compliance programs we have encountered are the anti-money-laundering and anti-sexual-

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[273] *Id.*

[274] As we note in our answer to Question 325, it would be far more effective to require "immediate" notification.

harassment training programs offered at financial institutions. Since all employees are required to learn the risks, indicators, and possible consequences of money laundering, these programs generally achieve excellent results. A similar program, combining electronic informational materials and a progression of case studies with attendant questions, might be effective in ensuring Volcker Rule compliance. Any such training program should be sure to train all employees at a banking entity in prohibited activities, permitted activities, and next steps in the event of a suspected violation.

We do not believe that Appendix C's elements III (Internal Controls), IV (Responsibility and Accountability), V (Independent Testing), or VII (Record Keeping) should occur solely at the enterprise level. In Element IV (Responsibility and Accountability), for example, the NPR outlines many specific levels of responsibility (including Trader Mandates and Business Line Managers) that would be difficult or impossible to track solely at an enterprise-wide level. Mandates from high in an organizational hierarchy may not address the specifics of an individual business line. For example, compliance with hedging exemption criteria will be much different for Global Corporate Bond Trading units than for European Equity Derivatives units.

For this reason, we believe compliance must occur at an enterprise-wide and a department-specific level. Enterprise-only compliance may dilute materiality at unit levels: a material breach at a subsidiary unit may not be material at the enterprise level. To prevent individual desks with small dealings from evading the rule, then, any Internal Control program should also be present at the trading unit level with oversight from senior management, compliance, and internal audit officials.

**Question 329. Should the proposed rule permit banking entities to comply with § _.20(b) of the proposed rule on an enterprise-wide basis? If so, why? What are the advantages and disadvantages of an enterprise-wide compliance program for smaller banking entities that are not subject to Appendix C? Please include a discussion relating to the infrastructure of an enterprise-wide compliance program and its management in the context of smaller banking entities. If enterprise-wide compliance or similar programs are used in other contexts, please describe your experience with such programs and how those experiences influence your judgment concerning whether or not you would choose an enterprise-wide compliance program in this context. Are there particular reasons why a enterprise-wide compliance program should be permitted for larger banking entities subject to the requirements of Appendix C, but not those that are subject to § _.20(b) of the proposed rule?**

Please see our answer to Question 328.

**Question 331. Are there efficiencies that can be gained through an enterprise-wide compliance program? If so, how and what efficiencies?**

We feel that efficiency can be gained by creating a set of standard policies (and trainings on those policies) for identifying and escalating rule violations (or suspected violations) and requiring adherence to these policies by all employees.

**Question 332. Would the complexities of various types of covered trading activity be adequately reflected in an enterprise-wide compliance program?**

It would not be efficient to mandate an enterprise-wide model of Internal Controls. Since each trading unit is different, quantitative measures may vary widely in their value and applicability to each individual unit. We suggest it would be more efficient to mandate enterprise-wide default Internal Controls, but require each individual trading unit to tailor these requirements to its own specific business. This tailoring, performed with the consent of an internal compliance team, would ensure that the analysis of metrics from each trading unit appropriately accounts for each unit's specific risk profile, and that abnormalities are not overlooked in the aggregate.

**Question 333. Should only outside parties be permitted to conduct independent testing for the effectiveness of the proposed compliance program to satisfy certain minimum standards? If so, why? Under the proposal, the independent testing requirement may be satisfied by testing conducted by an internal audit department or a third party. Should the rule specify the minimum standards for "independence" as applied to internal and/or external parties testing the effectiveness of the compliance program? For example, would an internal audit be deemed to be independent if none of the persons involved in the testing are involved with, or report to persons that are involved with, activities implicated by section 13 of the BHC Act? Why or why not?**

We feel that, while outside parties should be the preferred method of independent testing, internal audit departments may be acceptable *if* their work is subject to yearly reviews by qualified external parties with strict, verified independence.

Furthermore, we suggest that all internal compliance professionals be subject to a Volcker-specific licensing and registration process, similar to FINRA's Series 14[275] for NYSE compliance officers. Such standardized licensing processes ensure that a basic level of proper skills, knowledge, and accountability is shared by all relevant personnel throughout the industry.

**Question 334. Do you anticipate that banking entities that do not meet the thresholds specified in § _.20(c) would voluntarily comply with the proposed minimum standards in**

[275] The Series 14 examination, administered by FINRA, is a qualification examination intended to insure that the individuals designated as having day-to-day compliance responsibilities for their respective firms or who supervise ten or more people engaged in compliance activities have the knowledge necessary to carry out their job responsibilities. FINRA. FINRA Registration and Examination Requirements. http://www.finra.org/industry/compliance/registration/qualificationsexams/registeredreps/p011051 (last visited Feb. 5. 2012).

**Appendix C in order to effectively implement the six elements specified in § _.20(b)?Are there specific minimum standards that would not be practical or would be unattainable for a banking entity that does not meet the § _.20(c) thresholds? Please identify the minimum standard(s) and explain.**

It is likely that a vast majority of banking entities have existing compliance programs that are not substantially different in structure from the one described in this Proposed Rule. The level of detail, however, can be expected to diminish commensurate with levels of risk exposure. In general, such "voluntary compliance" will largely exist independent of this Rule.

**Question 335. In light of the size, scope, complexity, and risk of covered trading activities, do commenters anticipate the need to hire new staff with particular expertise in order to establish, maintain, and enforce the proposed compliance program requirement concerning covered trading activities or any subset of covered trading activities?**

If banking entities willingly and seriously move to implement the necessary changes to their relevant businesses to conform to this Rule, there should be minimal need for substantial changes to current compliance staff. If, however, banking entities move to restructure in order to subvert or evade the regulation, the job of the compliance department will become exponentially more difficult, and under these circumstances compliance departments may require substantial additional resources.

**Question 336. With respect to the proposed requirement that training should occur with a frequency appropriate to the size and risk profile of the banking entity's covered trading activities and covered fund activities, should there be a minimum requirement that such training shall be conducted no less than once every twelve (12) months? If so, why?**

There is no "size and risk profile" sufficiently small that relevant personnel would not benefit from frequent refreshers of important compliance policies and procedures. Indeed, the focus of this Proposed Rule should be to ensure that a thorough understanding of the compliance regime is second nature to **all** relevant parties, and a 1-year minimum requirement is a straightforward way to encourage and promote this priority.

**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?**

Consistent with the recommendations of the FSOC Study, CEOs should be required to provide yearly certification that the compliance program is adequate and effective, as this will "ensure the highest level of accountability."[276] It is our strong conviction that it will be difficult to effect real change at banking entities without committed leadership from the very top. This provision, in addition to being extremely practical, does nothing but hold banking entity executives to the same standards that many Americans in other sectors of the economy meet each day: taking responsibility for the work that occurs under their watch.

We also call for the establishment of a central repository for CEO attestations to the Agencies. In addition, the Agencies should require that Question 346's suggested supervisory methods (i), (ii), and (iii) be adopted and implemented by the banking entities. The use of these thorough procedures within the banking entity's supervisory channels will ensure that the Agencies, often constrained by limited resources, are included in the compliance process in the most effective way possible.

**Question 338. Do the proposed rule requirements relating to establishment and implementation of a compliance program pose unique concerns or challenges to issuers of asset-backed securities that are banking entities, and if so, why? Are certain asset classes particularly impacted by the proposed rule requirements, and if so, how?**

In light of recent and ongoing scandals throughout the Mortgage market specifically,[277] it is clear that negligent record keeping and minimal oversight would present significant challenges to the implementation of the proposed compliance regime. While this would certainly be problematic, it is the clearest possible demonstration of the dire importance that ALL banking entities adhere to such a system. It would be tremendously irresponsible of the Agencies to lose focus on these risky securities within existing ABS issuers, and we urge the abandonment of any inclination to relax these requirements for any trading activities.

**Question 339. How would existing issuers of asset-backed securities that are banking entities pay for establishing and implementing a compliance program? Should existing issuers of asset-backed securities that cannot comply with the compliance program requirements be excluded from the proposed definition of "banking entity"? Should such exclusion be limited, and if so, based on what factors? Are the proposed thresholds specified in § _.20(c) of the proposed rule and/or the allowance of an enterprise-wide**

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[276] FSOC Study, *supra* note 54. at 36 ("Agencies should also strongly consider requiring the CEO to attest publicly to the ongoing effectiveness of the internal compliance regime. This will ensure the highest level of accountability for the satisfaction of these expectations.").

[277] *See* Brady Dennis & Ariana Eunjung Cha, *In Foreclosure Controversy, Problems Run Deeper than Flawed Paperwork*, Washington Post, Oct. 7. 2010. *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/10/06/AR2010100607227.html.

**compliance program as set forth in Appendix C of the proposed rule sufficient to minimize these concerns for issuers of asset-backed securities?**

Banking entities that own existing issuers of asset-backed securities must face a choice. Either banks must find a way to fully comply with the Proposed Rule's requirements, or they must divest their ownership in such issuers. The notion of a blanket exclusion for existing asset-backed-security issuers is clearly at odds with the intentions of the statute to promote transparency and oversight in risky securities. We believe the Agencies should not be concerned with the means by which these necessary compliance procedures are internally funded.

**Question 342. To rely on the exemptions for permitted underwriting, market making-related, and risk-mitigating hedging activities, the proposed rule requires banking entities to establish the internal compliance program under § _.20 and, where applicable, Appendix C, designed to ensure compliance with the requirements of the applicable exemption (e.g., policies and procedures, internal controls and monitoring procedures, etc.). Do these requirements in the proposed rule impose undue cumulative burdens, such that the marginal benefit of a given requirement is not justified by the cost that the requirement imposes? If so, why does the proposed rule impose cumulative burdens and what are the costs of those burdens? Please explain the circumstances under which these burdens may arise. Is there a way to reduce or eliminate such burdens or requirements in a manner consistent with the language and purpose of the statute? For any requirements that impose undue burdens, are there other requirements that could be substituted that would more efficiently ensure compliance with the statute? Are there any requirements that the proposed rule imposes that are particularly effective, and if so, how can the Agencies make better use of these requirements?**

In general, the specific requirements of this Proposed Rule are sufficiently basic that if these limitations on covered trading activity were to pose significant burdens on a banking entity, such trading activity would most likely be considered inappropriate in any case. Please see Question 165 for further discussion of this issue.

**Question 343. Are the six elements of the proposed compliance program requirement mutually reinforcing and cost effective, or are there redundancies in the six elements? Please explain any redundant requirements in the policies and procedures, internal controls, management framework, independent testing, training, and recordkeeping requirements in § _.20(b) of the proposed rule or proposed Appendix C. Why are such requirements redundant, and how should the redundancy be addressed and remedied in the rule?**

Any truly thorough system will include a certain amount of overlap, and we find no redundancies in the Proposed Rule that do not serve to strengthen the overall program. The requirements in each Appendix, we feel, are mutually reinforcing.

**Question 344. A banking entity that meets the $1 billion or greater trading assets and liabilities threshold would be required under the proposed rule to comply with both the reporting and recordkeeping requirements in Appendix A with respect to quantitative measurements and the compliance program requirement in Appendix C. Are the requirements in these appendices mutually reinforcing and cost effective, or do the appendices impose redundant requirements on banking entities that meet the $1 billion threshold? Please explain any redundant requirements in the appendices and how such redundancy should be addressed and remedied in the rule.**

The requirements in each Appendix are mutually enforcing. For example, the quantitative measurements do much to provide an overview of a trading unit's risk profile, but fail to identify inappropriate hedging activity. The compliance requirements of Appendix C provide much more specific information as to the nature of compliant trading activity. While each provision separately may not provide sufficient clarity for an analysis of an entity's general compliance, in concert they seem to provide robust regulatory coverage.

**Question 345. Proposed Appendix C incorporates the quantitative measurements provided in proposed Appendix A in the internal controls requirement for banking entities that are engaged in covered trading activity and meet the $1 billion or greater trading assets and liabilities threshold. Do the requirements in proposed Appendix A and Appendix C impose undue cumulative burdens with respect to any elements (e.g., quantitative measurements), such that the marginal benefit of a given requirement is not justified by the cost that the requirement imposes? Please explain why the proposed appendices impose cumulative burdens, the costs of those burdens, and the circumstances under which these burdens may arise. Is there a way to reduce or eliminate such burdens or requirements in a manner consistent with the language and purpose of the statute? For any requirements in the appendices that impose undue burdens, are there other requirements that could be substituted that would more efficiently ensure compliance with the statute? Are there any requirements that the proposed appendices impose that are particularly effective, and if so, how can the Agencies make better use of these requirements?**

The requirements in Appendices A and C should impose no significant burden on any relevant banking entity, as the vast majority of the required procedures are already in place. Please see Question 174 for further discussion of this issue.

**Question 346. Should the relevant Agency prescribe any specific method by which the board of directors or similar corporate body reviews and approves the compliance program? For example, should the relevant Agency require that: (i) A chief compliance officer or similar officer present an annual compliance report including, as appropriate, recommended actions to be taken by the banking entity to improve compliance or correct any compliance deficiencies; (ii) the board review any such recommendations and**

**determine whether to approve them; and (iii) the banking entity notify the relevant Agency if the board declines to approve such recommendations, or approves different actions than those recommended in the compliance report? What are the advantages and disadvantages of such an approach?**

The Agency should require that all of these suggested methods—(i) (ii) and (iii)—are adopted and implemented by the banking entities. The use of these thorough procedures within the banking entities' supervisory channels will ensure that the Agencies, who are constrained by limited resources,[278] are included in the compliance process in the most effective way.

**Question 347. Should any portion of the Board's Conformance Rule be revised in light of other elements of the current proposed rule? If so, why and how?**

For further discussion, please see Question 271.

**Question 348. What are the expected costs and benefits of complying with the requirements of the proposed rule? We seek commenters' estimates of the aggregate cost or benefit that would be incurred or received by banking entities subject to section 13 of the BHC Act to comply. We also ask commenters to break out the costs or benefits of compliance to banking entities with each individual aspect of the proposed rule. Please provide an explanation of how cost or benefit estimates were derived. Please also identify any costs or benefits that would occur on a one time basis and costs that would recur. Would particular costs or benefits decrease or increase over time? If certain costs or benefits cannot be estimated, please discuss why such costs or benefits cannot be estimated.**

In their Cost and Benefits analysis, the Agencies suffer from what Keynes referred to as the "fetish of liquidity," that most "anti-social maxim of orthodox finance."[279] Instead of considering the Volcker Rule's impact on levels of employment, output or growth in all markets, the Agencies only focus their analysis on the potential impacts of the Rule on banks. The Proposed Rule gives scant mention to the precarious nature of proprietary trading, and the danger it has posed to global market health since the winnowing away of the Glass-Steagall Act.

Indeed, in its extensive Economic Impact analysis, the NPR glosses over the anticipated benefits of the Proposed Rule, and devotes disproportionate attention to the Rule's potential costs to banking entities. The Agencies' solicitude for the profitability of banking entities is undoubtedly heart-warming and encouraging to those entities, but is considerably less encouraging from the perspective of the general public.

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[278] FSOC Study, *supra* note 54. at 44 ("[S]ome Agencies face significant resource constraints and [] incorporation of these components, which include a review of trading practices to identify prohibited trading and distinguish permissible trading. would require significant new and specialized resources.").

[279] John Maynard Keynes. *The General Theory of Employment, Interest and Money* 155 (1936).

### A. Benefits for Depositors

Many of the costs identified in the NPR occur in the form a zero-sum game, wherein a banking entity's "cost" serves as a benefit to depositors and the public in general.

The NPR notes that the Rule's restrictions may cause banking entities to lose profits from certain activities that may be on the borderline of proprietary trading. While empirical data on the point is limited, one might reasonably conclude that a positive correlation exists between risks to depositors on the one hand, and the degree to which a bank's trading activities are proprietary in nature on the other. Assuming such a correlation, a banking entity's avoidance of borderline-proprietary trading would be marginally beneficial to investors. Lost profits in such cases are not unintended "costs," but rather the crux of Section 619's intended regulatory effect. The Congressional intent behind Section 619 was to refocus banks on customer-focused activities. An expansive interpretation of "proprietary trading" would reduce the risk of bank failure because only the most basic, customer-focused trades would make it through the Volcker Rule's gauntlet. This outcome would increase both depositor and investor confidence in banking entities, which in turn would increase real liquidity in the banking industry, and as a consequence, the overall market for credit. Increases in real liquidity would drive down real interest rates, improve consumption and help the global economy rebound from its currently depressed state.

The Economic Impact analysis is also deficient because it fails to include externalities in its discussion of the "costs" associated with bank compliance. Proprietary trading by a government-backstopped bank involves the distinct possibility of the bank needing to be bailed out, whether through depositors' funds, Federal Reserve financing, or taxpayer subsidies. The costs associated with these forms of bailout[280] must be included in the equation when considering the economic impact of the Proposed Rule. To the extent that banks face costs from their compliance obligations or from lost proprietary trading profits, depositors and the public are concomitantly saved the externality costs of potential bailouts.

### B. Impact on Artificial Liquidity

The NPR extensively discusses the possibility that the Proposed Rule's restrictions on proprietary trading will cause reduced liquidity and expanded credit spreads, especially in currently illiquid markets.

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[280] According to non-partisan government figures, the Federal Reserve loaned approximately $16 trillion to banks during the recent financial crisis. Phil Kuntz & Bob Ivry, *Fed Once-Secret Loan Crisis Data Compiled by Bloomberg Released to Public*, Bloomberg, Dec. 23, 2011, *available at* http://www.bloomberg.com/news/2011-12-23/fed-s-once-secret-data-compiled-by-bloomberg-released-to-public.html.

First and foremost, the Congressional intent behind Section 619 is to re-orient banks toward stable, customer-focused activities. This necessarily involves a shift away from trading in risky, illiquid markets. It should be noted that the Proposed Rule does not prohibit proprietary trading by all entities. Rather, it focuses solely on government-backstopped banks that have access to easy money through the Federal Reserve and customer deposits. Thus, even if "banking entities" are precluded from making illiquid markets, those markets can continue to be underwritten by conventional investment banks. Thus, any supposed impact on overall liquidity or credit spreads is questionable.

Moreover, much of the so-called "liquidity" that the banks have engineered, especially in opaque OTC markets, can be most appropriately termed "artificial liquidity." As one commentator notes, the "very belief that the proliferation of financial derivatives and securitization techniques has enhanced global liquidity has been [the] core illusion driving the sub-prime bubble in the USA."[281]

Proprietary trading involves buying and selling purely for speculative reasons that have little to do with a true assessment of a financial position's underlying value. This creates inefficiencies in the market price of such positions. True price discovery is impeded by the hyper-liquidity that is introduced by speculative proprietary traders. This hyper-liquidity, motivated by nothing more than expectations of short-term price movements, creates inefficient subsidies to buyers and sellers in the market. Depositors and the Federal Reserve unwittingly pay for these subsidies by funding banks' trading activities.

The Agencies should recognize the fact that certain markets *should* feature large credit spreads, simply because they involve truly risky products. Market makers in illiquid markets often impede natural market forces by engaging in self-interested, rent-seeking trades that create artificially narrow spreads. Thus, a reduction in proprietary trading may have the effect of increasing spreads, but that is actually a systemic benefit, not a cost, because those wider spreads will more accurately reflect the risk involved in those positions. Free of the market obfuscation created by proprietary traders, investors would be able to more efficiently allocate capital.

Hyper-liquidity may even paradoxically exacerbate market volatility. Liquidity that is propped up by banks for speculative reasons is apt to be withdrawn abruptly, when market conditions become disfavorable. This creates "liquidity black holes," which are "episodes in which the liquidity faced by a buyer or seller of a financial instrument virtually vanishes, reappearing again a few days or weeks later."[282] This disappearance and reappearance of capital creates market

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[281] Anastasia Nesvetailova. *Three Facets of Liquidity Illusion: Financial Innovation and the Credit Crunch*, 4 German Policy Studies 83, 94 (2008).
[282] Avinash Persaud, *Liquidity Black Holes: What are they and how are they Generated* (Apr. 2003), http://www.g24.org/Workshops/pers0403.pdf.

volatility, which is anathema to investors and depositors alike. A stable market with moderate credit spreads would be a more salutary alternative to this scenario.

Even if illiquid markets were somehow debilitated by the Volcker Rule, there would likely be minimal impact on overall market efficiency and capital formation. If banks are constrained in their ability to conduct legitimate market making, this will create market pressure for financial instruments to move to established exchanges and ECNs, which empirical studies demonstrate to be relatively efficient and safe.[283] OTC markets typically feature inordinate levels of leverage that lead to non-Pareto optimal levels of default risk.[284] Indeed, as one commentator noted, "[i]t is surprising that banking authorities have not [explicitly] required banks to move [] derivatives market-making activity to a centralized exchange where transparency is enhanced and bank exposure to counterparty default risk is greatly reduced."[285] A reduction in the size of a dealer-made market would siphon investments into efficient, transparent and less-risky alternatives. The primary utility of illiquid instruments seems to be in generating lucrative fees for originators and market makers. The more "exotic" the instrument, the higher the potential for compensation for no reason other than that instrument's opacity.

### C. Benefits for Banking Entities and Investors

Many of the "costs" identified in the NPR are actually benefits to banking entities, investors and depositors. In fact, the banking industry as a whole has much to gain from strong enforcement of the Proposed Rule. The premier investment bank, Goldman Sachs, has acknowledged that a harsh interpretation of the Volcker Rule will actually boost banks' profitability:

> [Goldman Sachs Group Inc. Chief Financial Officer David] Viniar said on Wednesday that if regulators impose strict trading limits, Goldman would be forced to turn over assets more quickly, and would be more hesitant to buy securities from clients that it could not immediately sell. While the executive stopped short of saying Goldman would convert to an agency trading model—which matches buyers and sellers before executing a trade—he did indicate the bank would start buying securities at lower prices and selling them at higher

[283] *See* Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. Chi. L. Rev. 219 (2009) ("[M]any large [financial institutions] act like markets in over-the-counter interest rate, currency and credit default swaps. and other more complex derivatives. being long and short similar contracts. This large degree of derivative exposure by [financial institutions] raises some serious questions and makes it all the more important to have strong board oversight of [their] derivative risk exposure.").

[284] Viral Acharya & Alberto Bisin. Centralized versus Over-The-Counter Markets. Mar. 16. 2010, http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/acharya_bisin_otc.pdf.

[285] Masulis & Thomas, *supra* note 283. at 249 n.106.

> prices to reflect the risk of taking on trades. Those wider "bid-ask spreads" would make trading more expensive for clients, but help boost Goldman's returns.[286]

We implore the Agencies to give Goldman what it wants, in this respect.

A microeconomic analysis also demonstrates that harsh enforcement will benefit the banking industry. The banking industry is essentially an oligopoly,[287] with only a handful of major players, especially vis-à-vis trading in illiquid markets. If a bank has to divest itself of proprietary trading units or hedge funds, that only serves to dilute risk across a greater number of entities, which in turn reduces the risk that any of those entities will be considered "Too Big to Fail." As the Agencies know, many of the premier banking entities are, at present, considered to be "Too Big to Fail." This creates a moral hazard in that those institutions are incentivized to undertake catastrophic risks because they enjoy an implied promise of impunity that can take the form of government bailouts, unfettered access to the discount window, easy financing via quantitative easing and other Federal Reserve policies. Strong enforcement will put pressure on banks to increase in number and reduce in size. Under classical economic theory, the most efficient markets are typically those having an almost infinite number of competitors, while the most inefficient ones are monopolies and oligopolies.[288] A competitive market will induce banking institutions to move away from the pursuit of exotic structured transactions simply for the purpose of reaping profits for themselves, and toward the offering of customer-focused banking services with less consolidation of risk. Investors will be protected through "free market regulation," in that their interests will be promoted simply as a consequence of natural market principles. In a competitive market, banks will have strong incentives *not* to engage in risky or conflicted transactions, because doing so could lose them future business. The absence of these negative factors could serve as a competitive advantage among competing firms. Exploited customers or depositors can "vote with their feet" and move their business to smaller, less risky banks. However, when there are only a handful of "sophisticated" banks for depositors and customers to choose from, opportunities for exploitation abound. In short, market efficiency will only be promoted if the Volcker Rule is vigorously enforced, and banking services are routed to smaller competitors as a consequence.

The NPR suggests that foreign banks may gain a competitive advantage because regulations like the Volcker Rule might not exist abroad. This reasoning is predicated on the assumption that having the ability to decimate the world financial system through risky proprietary trading is a competitive advantage; it is not. A strong implementation of the Volcker Rule would actually create a competitive advantage for American banks. Depositors and investors can be confident

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[286] Lauren Tara LaCapra, *Goldman Looks on the Bright Side of Volcker Rule*. Reuters, Feb. 8. 2012, *available at* http://www.reuters.com/article/2012/02/08/us-goldman-volcker-idUSTRE8171UE20120208.

[287] Adam Davidson, *It's the Economy: The Wild West of Finance*. N.Y. Times, Dec. 7, 2011, http://www.nytimes.com/2011/12/11/magazine/adam-davidson-wild-west-of-finance.html ("There are nearly 8,000 banks in the United States. but the top 20 control more than 90 percent of the market.").

[288] *See* K. Jothi Sivagnanam, *Business Economics* 155-56 (2010).

that their money is safe when dealing with a well-regulated, customer-focused bank. Conversely, these parties lose confidence where banks operate in a self-interested fashion, with few regulatory checks. Thus, American banking entities can only benefit from a Volcker Rule that "has teeth."

### D. Any Costs to Banking Entities are Justified

Section 619 was not passed with any additional funding allocated to the Agencies for actual enforcement. Thus, many of the costs associated with the Proposed Rule are being transferred to banking entities themselves, primarily in the form of recordkeeping and compliance obligations. This is an entirely appropriate outcome, especially given the fact that much of the Rule's complexity is due to the banks' lobbying efforts. The original Volcker Rule was not the 500-page behemoth it has become. The additional complexity exists as a direct consequence of the innumerable loopholes, exceptions and exemptions that the banks requested. This point was recently recognized by Representative Barney Frank, who informed the Agencies' heads during the recent House Financial Services Committee's hearing on the Volcker Rule that, "to some degree [banks] are complaining about you having accommodated them."[289] The banks now have what they wanted—an inordinately convoluted Rule—and must be required to pay for it.

Perhaps the most galling aspect of the banks' behavior in the last few years has been their inexorable insistence on issuing large-scale bonuses to their employees, despite sending the global economy into a tailspin. These banks have no compunction in borrowing 60-120% of the nation's GDP ($7.7 or $16 trillion dollars, depending on the estimate) from the Federal Reserve[290] on one hand, and contemporaneously issuing outlandish bonuses to executives, largely as rewards for highly speculative transactions.[291] If banks end up facing heightened costs from the Proposed Rule, they are free to defray such costs from compensation, and impose pay packages that are less outrageous in the extent to which they reward risky behavior. Similarly, the argument that the banks will not be able to hire and retain the best talent rings hollow when

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[289] Phil Mattingly and Cheyenne Hopkins, *Volcker Rule Regulators Resist Lawmakers Calls to Scrap Proposal*, Bloomberg Businessweek, Jan. 24, 2012, *available at* http://www.businessweek.com/news/2012-01-24/volcker-rule-regulators-resist-lawmakers-calls-to-scrap-proposal.html.

[290] Bill McGuire, *Fed Loaned Banks Trillions in Bailout, Bloomberg Reports*, ABC News, Nov. 28, 2011, http://abcnews.go.com/blogs/business/2011/11/fed-gave-banks-trillions-in-bailout-bloomberg-reports/. By comparison, the entire inflation-adjusted GDP of the United States as of the last quarter was only $13.35 trillion. Timothy R. Homan, *Economy in U.S. Surpasses Pre-Recession Level After 15 Quarters*, Bloomberg Businessweek, Oct. 31, 2011, *available at* http://www.businessweek.com/news/2011-10-31/economy-in-u-s-surpasses-pre-recession-level-after-15-quarters.html. The $7.7 trillion figure may actually under-estimate the total amount loaned. A July 21, 2011 study by the Government Accountability Office indicated that the "total transaction amounts" for Federal Reserve lending actually totaled a staggering $16 trillion. Gov't Accountability Office, GAO-11-696, Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance Needed 131 (2011).

[291] Bank of America paid investment-banking employees bonuses of $4.4 billion, or an average of $400,000 per person. *See* David Mildenberg, *Bank of America Said to Pay Average Bonus of $400,000*, Bloomberg, Feb. 3, 2010, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aB9F9yg63I0o.

one considers the cataclysmic shift in banking that the Volcker Rule envisions. Banks must now conduct safe, "plain vanilla," customer-focused transactions. If the "best and brightest" eschew jobs that facilitate bank stability, then banks (not to mention depositors) are better off without that "talent."

The Agencies recognize that most banks have elaborate compliance structures already in place to address other rules and regulations. Even if such banks incur initial sunk costs in implementing the Proposed Rule's recordkeeping and compliance framework, over time the marginal costs associated with that framework should be minimal. Banks can utilize the "economies of scale" they already enjoy by virtue of existing compliance frameworks. In the long run, any costs placed on banking entities by a vigorously enforced Volcker Rule will pale in comparison to the benefits to be enjoyed by depositors and the general public. Indeed, the Office of the Comptroller of the Currency has estimated that, given extant compliance infrastructure, Volcker Rule record-keeping will only cost banks approximately $50 million a year. This amounts to a mere 0.3% of the estimated $15.8 billion that the top six American banks lost on proprietary trading in the recent crisis.[292]

The NPR notes that the Volcker Rule may stifle financial innovation, and cause the market for securitization and other structured products to dry up. However, the utility of these products is questionable in any case. One can hardly argue that capital markets were inefficient or illiquid before the burgeoning of esoteric financial products in the last 15 years. After all, the late 1990's saw a burst of real economic growth driven by technological innovation, which was in turn dependent on the ready availability of capital. Indeed, many well-informed people believe that securitizations and similar "innovations" have no productive value other than as a fee generation mechanism for financial companies. For example, in describing structured finance derivatives, President Bill Clinton has stated that "[w]e created all these new securities which have no value and create no jobs."[293] In his view, the markets as a whole would be better benefited by longer-term, less complex forms of capitalization.[294] Paul Volcker has expressed a similar sentiment with respect to exotic financial instruments: "I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth—one shred of evidence."[295] A similar view has also been espoused by Robert Kuttner, who has stated that:

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[292] *See* Editors. *Do not Give Up on the Sensible Ideas the Dodd-Frank Act Offers Banks: View*. Bloomberg View. Dec. 27, 2011. *available at* http://www.bloomberg.com/news/2011-12-28/don-t-give-up-on-the-sensible-ideas-the-dodd-frank-act-offers-banks-view.html.

[293] Robert Lenzner, *Clinton's Cure For Capitalism*, Forbes.com, Sep. 25, 2009, http://www.forbes.com/2009/09/25/clinton-global-initiative-personal-finance-investing-ideas-bill-clinton.html.

[294] *See id.*

[295] Interview with Satyajit Das, *The Financial Zoo: An Interview with Satyajit Das – Part I*. Naked Capitalism, Sep. 7. 2011, http://www.nakedcapitalism.com/2011/09/the-financial-zoo-an-interview-with-satyajit-das-%E2%80%93-part-i.html (last visited Nov. 12. 2011) ("US financial services increased its share of value added from 2% to 6.5% but is that a reflection of your financial innovation, or just a reflection of what you're paid?").

> [i]t's time to simply abolish credit default swaps and similar exotic, impenetrable, essentially unregulated securities. They add nothing to economic efficiency, they line bankers' pockets, and they add massively to global financial risks. Swaps were only invented in the 1990s. The world got along beautifully—much better in fact—without them.[296]

These viewpoints have empirical support. A comprehensive survey of empirical economic data has revealed little evidence for the existence of the financial innovation that is giddily extolled by financial institutions and their proponents.[297]

Financial innovation goes hand-in-hand with increased concentrations of risk and pricing opacity. The banking model has shifted away from "old-fashioned" prudential banking of the George Bailey variety, in favor of an "originate and distribute" model that revels in risk-taking. "[T]he banker today pays less attention to credit evaluation since the interest and principal on the loans originated will be repaid not to the bank itself, but to the final buyers of the collateralized assets."[298] From a Pareto-optimal, macroeconomic perspective, the markets would actually benefit if the Volcker Rule were to reduce "financial innovation" by government-backstopped banking entities.

Various commentators[299] have suggested that the Proposed Rule's restrictions on fund ownership would require banks to sell their assets under sub-optimal, "fire sale" conditions, especially in illiquid markets. However, these commentators overstate the Volcker Rule's impact on liquidity. For instance, junk bond trading volumes are at record levels, which has led one industry insider to opine:

> This rise in volume is a strong indication that brokerage houses were crying wolf about the reduced liquidity that was supposedly resulting from the anticipated implementation of the Volcker Rule.[300]

Moreover, the assumption behind the "fire-sale" argument seems to be that the Proposed Rule's implementation is imminent. In actuality, even after the Rule is implemented, banks can enjoy

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[296] Robert Kuttner, *Abolish Credit Default Swaps*, Huffington Post, http://www.huffingtonpost.com/mobileweb/2011/10/31/credit-default-swaps_n_1067152.html (last visited Nov. 11, 2011).

[297] *See* W. Scott Frame & Lawrence J. White, *Empirical Studies of Financial Innovation: Lots of Talk, Little Action?*, 42 J. Econ. Lit. 1 (2004).

[298] Anastasia Nesvetailova. *The End Of A Great Illusion: Credit Crunch And Liquidity Meltdown* 16 (2008), http://www.diis.dk/graphics/publications/wp2008/wp2008-23_credit_crunch_and_liquidity_meltdown.pdf.

[299] *See* Dave Clarke & Joe Rauch. *Banks Seek to Avoid Volcker Rule "Fire Sale"*, Reuters. Dec. 7. 2011, *available at* http://www.reuters.com/article/2011/12/07/us-financial-regulation-volcker-idUSTRE7B60QZ20111207.

[300] Joseph Ciolli. *Junk-Bond Trading Rises to Most Since February: Credit Markets*, S.F. Chronicle. Jan. 26, 2012. *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/g/a/2012/01/26/bloomberg_articlesLYDHMY07SXKX01-LYF14.DTL&ao=all#ixzz1ktbQdhuz.

an automatic 2-year Conformance Period, followed by up to three 1-year extensions and/or a 5-year extension for illiquid funds. Allowing banks to conceivably hold assets until July 2022 is hardly indicative of a "fire sale" requirement. Indeed, most major banks have already shut down their proprietary trading desks,[301] well before the Proposed Rule has even gone into effect.

In summary, the Volcker Rule, if vigorously enforced, will re-orient banks toward conservative, customer-focused transactions. Even if major banks undergo significant costs in changing their business models to suit, those costs are required by Section 619 and are justified by the benefits to be had on a larger scale.

[301] *See, e.g.*, Maria Aspan, *Goldman Shutters Two Proprietary Trading Desks*, Reuters, Mar. 1, 2011, *available at* http://www.reuters.com/article/2011/03/01/goldmansachs-proptrading-idUSN0110849120110301.

# ANNEXURE B
# SUGGGESTED CHANGES TO REGULATION

This Appendix summarizes our suggestions for changes to the regulatory language of the Proposed Common Rules. Italics denote suggested additions, while strikethroughs denote suggested deletions.

## 1. Definition of Loan

*a. Preferred approach:*

We propose that the definition of loan at § _.2(q) be modified to read as follows:

(q) Loan means any loan, lease, extension of credit, or secured or unsecured receivable. *A loan shall not mean a position:*

1. *having the expectation of profits arising from a common enterprise which depends solely on the efforts of a promoter or third party,#*
2. *in which there is common trading for speculation or investment,#*
3. *that materially has the characteristics of a commodity, security, or derivative, or*
4. *that falls within within the scope of § .3(b)(3)(ii)*

## 2. Eliminate Category from the "Rebuttable Presumption" under Trading Account

*a. Preferred approach:*

Modify § _.3(b)(2)(ii)'s rebuttable presumption for certain positions as follows:

(ii) Rebuttable presumption for certain positions. An account shall be presumed to be a trading account if it is used to acquire or take a covered financial position, other than a covered financial position described in paragraph (b)(2)(i)(B) or (C) of this section, that the covered banking entity holds for a period of ~~sixty~~ one hundred eighty days or less, unless the covered banking entity can demonstrate, based on all the facts and circumstances, that the covered financial position, ~~either individually or as a category~~, was not acquired or taken principally for any of the purposes described in paragraph (b)(2)(i)(A) of this section.

## 3. Removal of Repo and Reverse Repo Accounts as Exclusions to the Definition of Trading Account

*a. Preferred approach:*

Remove §_.3(b)(2)(iii)(A) entirely.

*b. Alternative approach:*

Remove §_.3(b)(2)(iii)(A) entirely in favor of a new entry in §_.6, §_.6(e), that defines repurchase and reverse repurchase agreements as a permitted activity:

*§_.6(e) Permitted trading in repurchase and reverse repurchase agreements.*
*(1) The prohibition on proprietary trading contained in §l.3(a) does not apply to the purchase or sale by a covered banking entity of a covered financial position that is:*
*(i) A repurchase or reverse repurchase agreement pursuant to which the covered banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty;*
*(ii) That the agreement defined in (i) of this part adhere to a publicly-available, industry standardized master agreement; and*
*(iii) That the stated assets in the agreement defined in (i) of this part consist only of high-quality liquid assets.*

**4. Securities Lending**

*a. Preferred approach:*

Remove §_.3(b)(2)(iii)(B) entirely.

*b. Alternative approach:*

Modify §_.3(b)(2)(iii)(B) entirely in favor of a new entry in §_.6, §_.6(f), that defines securities lending as a permitted activity:

*§_.6(f) Permitted trading in securities lending agreements.*
*(1) The prohibition on proprietary trading contained in §l.3(a) does not apply to the purchase or sale by a covered banking entity of a covered financial position that:*
*(i)* Arise under a transaction in which the covered banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties; *and*
*(ii) The assets that the covered banking entity invests in using the proceeds of the securities lending transaction, in order to minimize risk to their clients, be restricted to high-quality liquid assets.*

**5. Liquidity Management**

*a. Preferred approach:*

Modify §_.3(b)(2)(iii)(C)(2) as follows:

> (2) Requires that any transaction ~~contemplated and authorized by the plan~~ be ~~principally~~ *solely* for ~~the purpose of managing the~~ *management of* liquidity of the covered banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;

Also, modify § .3(b)(2)(iii)(C)(3) to require that liquidity management positions "**consist only of high-quality liquid assets,**" and also to add the word "**reasonably**":

> (3) Requires that any position taken for liquidity management purposes be ~~highly liquid~~ *high-quality liquid assets,* and limited to financial instruments the market, credit and other risks of which the covered banking entity does not *reasonably* expect to give rise to appreciable profits or losses as a result of short-term price movements;

**6. Clarification of Exemption for Clearing Organizations**

*a. Preferred approach:*

Modify § _.3(b)(2)(iii)(D) to add "**clearing**" before "securities transactions"**:**

> (D) That are acquired or taken by a covered banking entity that is a derivatives clearing organization registered under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1) or a clearing agency registered with the SEC under section 17A of the Exchange Act (15 U.S.C. 78q–1) in connection with clearing derivatives or *clearing* securities transactions.

**7. Exemption for Underwriting**

***a. Preferred approach:***

Modify § _.4(a) to require exempted underwriting to occur only for registered securities:

> § _.4(a)(2)(ii): The covered financial position is a *registered* security;
>
> § _.4(a)(3): Definition of distribution. For purposes of paragraph (a) of this section, a distribution of securities means an offering of securities~~, whether or not subject to registration under the Securities Act,~~ that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.

§ _.4(a)(4): Definition of underwriter. For purposes of paragraph (a) of this section, underwriter means:

(ii) A person who has agreed with an issuer of securities or selling security holder:
(A) To purchase *registered* securities for distribution;
(B) To engage in a distribution of *registered* securities for or on behalf of such issuer or selling security holder; or
(C) To manage a distribution of *registered* securities for or on behalf of such issuer or selling security holder; and

(ii) A person who has an agreement with another person described in paragraph (a)(4)(i) of this section to engage in a distribution of such *registered* securities for or on behalf of the issuer or selling security holder.

Also, modify §_.4 (a) to remove weak language consider a banking entity's intent.

§ _.4(a)(vi) The underwriting activities of the covered banking entity ~~are designed to~~ generate revenues ~~primarily~~ *solely* from fees, commissions, underwriting spreads or other income not attributable to:

(A) Appreciation in the value of covered financial positions related to such activities; or
(B) The hedging of covered financial positions related to such activities; and

§ _.4(a)(vii) The compensation arrangements of persons performing underwriting activities *do* ~~are designed~~ not ~~to~~ reward proprietary risk-taking.

**8. Disgorgement of Proprietary Gains Made by Underwriting**

*a. Preferred approach:*

Add a new criteria to the underwriting exemption, §_.4(a)(2)(viii):

*§ .4(a)(2)(viii): The covered banking entity disgorges any proprietary gains, as defined in § _.4(a)(2)(vi)(A) and § _.4(a)(2)(vi)(B), to the banking entity's depositors, on a pro-rated basis according to the amount on deposit, or to another party that is not affiliated with the banking entity, as determined by [Agency].*

**9. Definition of Permitted Market Making-Related Activities in** §_.4(b)(1)

*a. Preferred approach:*

We propose the inclusion of the following language into _4(b)(1):

(1) Permitted market making-related activities. The prohibition on proprietary trading contained in § __.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with the covered banking entity's market making-related activities, *provided such activities do not include or incorporate:*

- *(i) Assets whose changes in values cannot be adequately mitigated by effective hedging;*
- *(ii) New products with rapid growth, including those that do not have a market history;*
- *(iii) Assets or strategies that include significant embedded leverage;*
- *(iv) Assets or strategies that have demonstrated significant historical volatility;*
- *(v) Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and*
- *(vi) Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;*

**10. Definition of Market Maker in** §_.4(b)(2)(ii)

*a. Preferred approach:*

Here we propose an alternative definition of market maker:

> § _.4(b)(2)(ii) The trading desk or other organizational unit that conducts the purchase or sale holds itself out as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular ~~or~~ *and* continuous basis;

**11. Compensation Arrangements:**

*a. Preferred approach:*

We propose the following change to the language of Section § __.4(b)(2)(vii) of the proposed rule:

> § _.4(b)(2)(vii) The compensation arrangements of persons performing the market making-related activities ~~are designed~~ *do* not to reward proprietary risk-taking

Additionally, the explanation of this sixth criterion in the supplementary information should be changed to the following:

> Under § __.4(b)(2)(vii) of the proposed rule, the compensation arrangements of persons performing market making-related activities at the banking entity ~~must be designed~~ not ~~to~~ encourage or reward proprietary risk-taking. Activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position held in inventory, rather than success in providing effective and timely intermediation and liquidity services to customers, are inconsistent with permitted market making-related activities. ~~Although a banking entity relying on the market-making exemption may appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed principal risk retained, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not proprietary risk-taking~~.

Furthermore, the same change should be made to the language regarding the Risk-Mitigating Hedging exemption.

> Seventh, § _.5(b)(2)(vi) of the proposed rule requires that the compensation arrangements of persons performing the risk-mitigating hedging activities ~~are designed~~ *do* not ~~to~~ reward proprietary risk-taking. Hedging activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position, rather than success in reducing risk, are inconsistent with permitted risk-mitigating hedging activities.

**12. Disgorgement of Proprietary Gains Made by Market Making**

*a. Preferred approach:*

Add a new criteria to the market making exemption, § _.4(b)(2)(viii):

> *§_.4(b)(2)(viii): The covered banking entity disgorges any proprietary gains, as defined in § _.4(b)(2)(v)(A) and § _.4(b)(2)(v)(B), to the banking entity's depositors, on a pro-rated basis according to the amount on deposit, or to another party that is not affiliated with the banking entity, as determined by [Agency].*

**13. Hedging Documentation**

*a. Preferred approach:*

We propose the amendment of the wording of § _.5(c) to the following:

(c) Documentation. With respect to any purchase, sale, or series of purchases or sales conducted by a covered banking entity pursuant to this Sec. --.5 for risk-mitigating hedging purposes ~~that is established at a level of organization that is different than the level of organization establishing or responsible for the positions, contracts, or other holdings the risks of which the purchase, sale, or series of purchases or sales are designed to reduce~~, the covered banking entity must, at a minimum, document, *with particularity,* at the time the purchase, sale, or series of purchases or sales are conducted risk-mitigating purpose of the transaction and identify the risks of the individual or aggregated positions, contracts, or other holdings of a banking entity that the transaction is designed to reduce.

**14. Permitted Trading on Behalf of Customers**

*a. Preferred approach:*

Remove "investment adviser, commodity trading advisor" from §_.6(b)(2)(i)(A):

(A) Is conducted by a covered banking entity acting as ~~investment adviser, commodity trading advisor,~~ trustee, or in a similar fiduciary capacity for a customer;

**15. Riskless Principal Transaction**

*a. Preferred approach:*

We suggest the following alternative definition of riskless principal transaction at § _.6(b)(2)(ii):

(ii) The covered banking entity is acting as riskless principal in a transaction in which the covered banking entity, after receiving an order to purchase (or sell) a covered financial position from a customer, purchases (or sells) the covered financial position for its own account, to offset a ~~contemporaneous~~ *simultaneous* sale to (or purchase from) the customer, *where the purchase price and offsetting sale price are identical, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee*;

**16. Client, Customer Counterparty**

*a. Preferred approach:*

We propose that the phrase, client, customer, or counterparty, which is referenced throughout the Proposed Rule yet is undefined be defined as follows::

> *A customer is a counterparty that is NOT itself a covered banking entity, and with which a banking entity has a direct and substantive relationship, which was initiated by the client prior to the transaction.*

We further propose that the term "customer" be defined as follows:

> *Customer means an investor engaged in a continuing, direct, and pre-existing relationship with a banking entity where a banking entity provides one or more financial products or services to the investor.*

**17. Definition of Material Conflict of Interest**

*a. Preferred approach*

Remove ", or substantially mitigate," from §_.8(b)(1)(ii).

> (ii) Makes such disclosure explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate~~, or substantially mitigate,~~ any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

**18. Definition of Covered Fund**

*a. Preferred approach:*

Modify § _.10(b)(1) to add the elements 10(b)(1)(v) and (vi):

> *(v) An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a 1 et seq.), but for Section 3(c)(2) of that Act, or Rule 3a-1 or Rule 3a-6 of the Rules and Regulations promulgated under that Act, and*
>
> *(vi) Any issuer that the Commission deems to be a covered fund, should the Commission deem that said issuer exhibit the characteristics of a fund that takes on proprietary trading activities;*

**19. Definition of Ownership Interest**

*a. Preferred approach:*

**Remove** § _.10(b)(3)(ii)(A), which exempts carried interest from the definition of ownership interest.

Revise § _.10(b)(3)(i) as follows:

> (i) Ownership interest means any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, or any derivative of such interest~~,~~ *or any interest that derives its value from the performance or value of the covered fund*.

**20. Definition of Prime Brokerage Transaction**

*a. Preferred approach:*

The Agencies should **remove** "financing" and "securities borrowing or lending services" from the definition of prime brokerage in § _.10(b)(4):

> (4) Prime brokerage transaction means one or more products or services provided by a covered banking entity to a covered fund, such as custody, clearance, ~~securities borrowing or lending services,~~ trade execution, or ~~financing,~~ data, operational, and portfolio management support.

**21. Permitted Employee Investments**

*a. Preferred approach:*

Modify § _.11(g) to remove "or other services":

> (g) No director or employee of the covered banking entity takes or retains an ownership interest in the covered fund, except for any director or employee of the covered banking entity who is directly engaged in providing investment advisory ~~or other services~~ to the covered fund;

**22. Ownership limits in Covered Funds**

*a. Preferred approach:*

Redefine § _.12(a)(2)(i) by adding a new entry, § _.12(a)(2)(i)(C):

*(C) May at no time during the initial 1 year following the establishment of the fund (or such longer period as may be provided by the Board pursuant to paragraph (e) of this section) exceed $10 million, or 3% of Tier 1 capital, whichever is less.*

**23. Include Committed Funds in Ownership Interest**

*a. Preferred approach:*

Amend §§ _.12(b)(2)(i) and _.12(b)(2)(i)(A) as follows:

§ _12(b)(2)(i): The aggregate amount of all ownership interests of the covered banking entity shall be the greater of (without regard to committed funds not yet called for investment):

§ _.12(b)(2)(i)(A): The value of any investment or capital contribution made with respect to all ownership interests held under § _.12 by the covered banking entity in the covered fund, *including committed funds not yet called for investment*, divided by the value of all investments or capital contributions, respectively, made by all persons in that covered fund, *including committed funds not yet called for investment*;

**24. Valuing Investments in Covered Funds**

*a. Preferred approach:*

Amend § _.12(b)(4) as follows:

§ _12(b)(4): Methodology and standards for calculation. For purposes of determining the amount or value of its investment in a covered fund under this paragraph (b), a covered banking entity must calculate its investment in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests, *except that committed funds not yet called for investment shall be counted toward the value of the total investment in the covered fund regardless of the standards used by the covered fund.*

**25. Compensation "Hedging"**

*a. Preferred approach:*

We suggest that the Agencies **remove the permitted "hedging" of compensation arrangements** through an ownership interest in a covered fund provided by § _.13(b)(1)(i)(B).

*b. Alternative Approach:*

Add the following **new criteria** be to § _.13(b)(2)(ii)(B)(2) in order to prevent rule evasion (additions in italics):

> § _.13(b)(2)(ii)(B)(2) Is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, that covered fund, *provided that*:
>
> *(i) No "hedge" is permitted during the one year following the establishment of the fund.*
>
> *(ii) All proceeds from the "hedge" must be paid entirely to the investment advisor, and*
>
> *(iii) The "hedge" in the covered fund that does not exceed 3 percent of the total outstanding ownership interests in the fund;*

**26. Remove Bank Owned Life Insurance as a Covered fund activities determined to be permissible.**

*a. Preferred approach:*

Remove § _.14(a)(1), Bank owned life insurance.

**27. Limitations on Prime Brokerage with a Covered Fund: Third-party Funds Only**

*a. Preferred approach:*

Modify § _.16(a)(2)(ii) to include the phrase "third party":

> (ii) Enter into any prime brokerage transaction with any *third party* covered fund in which a covered fund managed, sponsored, or advised by such covered banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest, if:

**28. Limitations on Prime Brokerage with a Covered Fund: Investment Limits**

*a. Preferred approach:*

Add a new entry to § _.16(a)(2)(ii), § _.16(a)(2)(ii)(D):

> *(D) The covered banking entity has divested from the covered fund such that its their ownership interest in the covered fund is no more than the 3% de minimis investment limitation set forth in § _.12(a)(1)(ii);*

**29. Extension of Required Time to Make and Keep Records**

*a. Preferred approach:*

Amend § _.20(b)(6) to read 6 years instead of 5:

> (6) Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a covered banking entity must promptly provide to [Agency] upon request and retain for a period of no less than *6* years.

**30. Change "Timely Notification" to "Immediate Notification" in Appendix C**

*a. Preferred approach:*

Modify Appendix C, III(A), "Analysis and quantitative measurements" in the bullet that begins "Immediate review and compliance investigation . . . " as follows:

> Immediate review and compliance investigation of the trading unit's activities, escalation to senior management with oversight responsibilities for the applicable trading unit, *immediate* notification to [Agency] *(where 'immediate' shall mean no later than one day following the time when the concern was raised internally)*, appropriate remedial action (e.g., divesting of impermissible positions, cessation of impermissible activity, disciplinary actions), and documentation of the investigation findings and remedial action taken when the quantitative measurement, considered together with the facts and circumstances, suggests a reasonable likelihood that the trading unit has violated any part of section 13 of the BHC Act and this part.

# ANNEXURE C
# SUGGGESTED CHANGES TO THE PROPROSED RULE'S MARKET-MAKING COMMENTARY

III. Commentary

A. Overview of Market Making-Related Activities

In the context of trading activities in which a covered banking entity acts as principal, market making-related activities generally involve the covered banking entity either (i) in the case of market making in a security that is executed on an organized trading facility or exchange, passively providing liquidity by submitting resting orders that interact with the orders of others on an organized trading facility or exchange and acting as a registered market maker[1], where such exchange or organized trading facility provides the ability to register as a market maker, or (ii) in other cases, providing an intermediation service to its customers by assuming the role of a counterparty that stands ready to buy or sell a position that the customer wishes to sell or buy. A market maker's "customers" generally vary depending on the asset class and market in which the market maker is providing intermediation services. In the context of market making in a security that is executed on an organized trading facility or an exchange, a ``customer'' is any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant. In the context of market making in a covered financial position in an over-the-counter market, a "customer" generally would be a market participant, *that is not itself a covered banking entity*, that makes use of the market maker's intermediation services, ~~either~~ by requesting such services ~~or entering into a continuing relationship with the market maker with respect to such services.~~

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, resulting in more liquid markets and less volatile prices. 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. ~~To the extent that it can,~~ a market maker will eliminate some or all of the price risks to which it is exposed. ~~However, in some cases, the risks posed by one or more positions may be sufficiently complex or specific that the risk cannot be fully hedged. In other cases, although it may be possible to hedge the risks posed by one or more positions, the cost of~~

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[1] The status of being a registered market maker is not, on its own, a sufficient basis for relying on the exemption for market making-related activity contained in Sec. _.4(b). Registration as a market maker generally involves filing a prescribed form with an exchange or organized trading facility, in accordance with its rules and procedures, and complying with the applicable requirements for market makers set forth in the rules of that exchange or organized trading facility. See, e.g., Nasdaq Rule 4612, New York Stock Exchange Rule 104, CBOE Futures Exchange Rule 515, BATS Exchange Rule 11.5.

~~\2\ In certain cases, depending on the conventions of the relevant market (e.g., the over-the-counter derivatives market), such a "customer" may consider itself or refer to itself more generally as a "counterparty"~~

~~doing so may be so high as to effectively make market making in those positions uneconomic if complete hedges were acquired.~~ In ~~such~~ *some* cases, in order to provide effective intermediation services, market makers are required to retain ~~at least~~ some risk for ~~at least~~ some period of time with respect to price movements of retained principal positions and risks. The size and type of risk that must be retained in such cases may vary ~~widely~~ depending on the type and size of the positions, the liquidity of the specific market, and the market's structure, *but in all cases will be limited to a size that can be reasonably disposed of in the near term under normal market conditions and poses no significant risk in unexpected market moves or changes in liquidity.* As the liquidity of positions increases, *both* the frequency with which a market maker must take or retain risk in order to make a market in those positions, *as well as the reasonable size of those positions*, generally decreases.

The profitability of market making-related activities relies on forms of revenue that reflect the value of the intermediation services that are provided to the market maker's customers. These revenues typically take the form of explicit fees and commissions or, in markets where no such fees or commission are charged, a bid-ask ~~or similar~~ spread that is generated by charging higher prices to buyers than is paid to *contemporaneous* sellers of comparable instruments. In the case of a derivative contract, these revenues reflect the difference between the cost of entering into the derivative contract and the cost of hedging incremental, residual risks arising from the contract. These types of ``customer revenues" provide the primary source of a market maker's profitability. Typically, a market maker holds ~~at least~~ some risk with respect to price movements of retained principal positions and risks. As a result, the market maker also incurs losses or generates profits as price movements actually occur, but such losses or profits are incidental to customer revenues and *will always be* significantly limited by the banking entity's hedging activities. Customer revenues, not revenues from price movements, predominate. The appropriate proportion of ``customer revenues" to profit and losses resulting from price movements of retained principal positions and risks varies depending on the type of positions involved, the typical fees, commissions, and spreads payable for transactions in those positions, and the risks of those positions, *but in all cases this proportion will be very high.* ~~As a general matter, the proportion of ``customer revenues" generated when making a market in certain positions increases as the fees, commissions, or spreads payable for those positions increase, the volatility of those positions' prices decrease, and the prices for those positions are less transparent.~~ Because a market maker's business model entails managing and limiting the extent to which it is exposed to movements in the prices of retained principal positions and risks while generating customer revenues that are earned, regardless of movements in the price of retained principal positions and risks, a market maker *always* ~~typically~~ generates significant revenue relative to the risks that it retains. Accordingly, a market maker will typically demonstrate consistent profitability and low earnings volatility ~~under normal market conditions~~. The appropriate extent to which a market maker will demonstrate consistent profitability and low earnings volatility varies depending on the type of positions involved, the liquidity of the positions, the price transparency of the positions, and the volatility of the positions' prices, *but the extent will be significant in all cases.* As a general matter, consistent profitability will decrease and earnings volatility will increase as the liquidity of the positions decrease, the volatility of the positions' prices increase, and the prices for the positions are less transparent.

As the primary purpose of market making-related activities is to provide intermediation services to its customers, ~~market makers focus their activities on servicing customer demands and typically only engage in transactions with non-customers to the extent that these transactions directly facilitate or support customer transactions. In particular,~~ a market maker generally only transacts with non-customers to the extent necessary to hedge or otherwise manage the risks of its market making-related activities, including managing its risk with respect to movements of the price of retained principal positions and risks, ~~to acquire positions in amounts consistent with reasonably expected near term demand of its customers,~~ or to sell positions acquired from its customers. The appropriate proportion of a market maker's transactions that are with customers versus non-customers varies depending on the type of positions involved and the extent to which the positions are typically hedged in non-customer transactions, *but in all cases this proportion will be high*. ~~In the case of a derivatives market maker that engages in dynamic hedging, the number of non-customer transactions significantly outweighs the number of customer transactions, as the derivatives market maker must constantly enter into transactions to appropriately manage its retained principal positions and risks as market prices for the positions and risks move and additional transactions with customers change the risk profile of the market maker's retained principal positions.~~

Because a market maker generates revenues primarily by transacting with, and providing intermediation services to, customers, a market maker typically engages in transactions that earn fees, commissions, or spreads as payment for its services. Transactions in which the market maker pays fees, commissions, or spreads—i.e. where it pays another market maker for providing it with liquidity services—are much less frequent, although in some cases obtaining liquidity services from another market maker and paying fees, commissions, or spreads may be necessary to prudently manage its risk with respect to price movements of retained principal positions and risks. The appropriate proportion of a market maker's transactions that earn, rather than pay, fees, commissions or spreads varies depending on the type of positions involved, the liquidity of the positions, and the extent to which market trends increase the volatility of its risk with respect to price movements of retained principal positions and risks, *but in all cases this proportion should be high.* As a general matter, the proportion of a market maker's transactions that earn rather than pay fees, commissions or spreads decreases as the liquidity of the positions decreases, and the extent to which the price volatility of retained principal positions and risks increases.

Finally, because the primary purpose of market making-related activities is to provide intermediation services to its customers, a market maker does not provide compensation incentives to its personnel that ~~primarily~~ reward proprietary risk-taking. ~~Although a market maker may take into account revenues resulting from movements in the price of retained principal positions and risks to the extent that such revenues reflect the effectiveness with which personnel have effectively managed the risk of movements in the price of retained principal positions and risks,~~ a market maker that provides compensation incentives relating to revenues ~~generally~~ does so *exclusively* through incentives that ~~primarily~~ reward customer revenues and effective customer service.

B. Overview of Prohibited Proprietary Trading Activities

Like permitted market making-related activities, prohibited proprietary trading involves the taking of principal positions by a covered banking entity. Unlike permitted market making-related activities, the purpose of prohibited proprietary trading is to generate profits as a result of, or otherwise benefit from, changes in the price of positions and risks taken. Whereas a market maker attempts to eliminate some or all of the price risks inherent in its retained principal positions and risks by hedging or otherwise managing those risks in a reasonable period of time after positions are acquired or risks arise, a proprietary trader *may* seek~~s~~ to capitalize on those risks, and generally only hedges or manages a portion of those risks when doing so would improve the potential profitability of the risk it retains. *Despite these very different intentions, the component trades and resulting risk profiles may be identical.* A proprietary trader does not *consider his counterparties to be* ~~have~~ ``customers" because a proprietary trader simply seeks to obtain the best price and execution in purchasing or selling its proprietary positions. A proprietary trader generates few if any fees, commissions, or spreads from its trading activities because it is not providing an intermediation service to any customer or other third party. *In the process of trading, however, he may appear to be capturing bid/offer spreads as a result of buying low and selling higher as a proprietary strategy.* Instead, a proprietary trader is likely to pay fees, commissions, or spreads to other market makers when obtaining their liquidity services is beneficial to execution of its trading strategy. Because a proprietary trader seeks to generate profits from changes in the price of positions taken, a proprietary trader typically provides compensation incentives to its personnel that primarily reward successful proprietary risk taking.

C. Distinguishing Permitted Market Making-Related Activities From Prohibited Proprietary Trading

*No changes in items 1-5.*

6. Compensation Incentives

~~Absent explanatory facts and circumstances,~~ the trading activity of a trading unit that provides compensation incentives to employees that ~~primarily~~ reward proprietary risk taking will be considered to be prohibited proprietary trading, and not permitted market making-related activity.

~~[The Agency] will base such a determination on all available facts and circumstances, including, among other things, an evaluation of: the extent to which compensation incentives are provided to trading unit personnel that reward revenues from movements in the price of retained principal positions and risks; the extent to which compensation incentives are provided to trading unit personnel that reward customer revenues; and the compensation incentives provided by other covered banking entities to similarly-situated personnel.~~