AMERICANS FOR FINANCIAL REFORM
ACCOUNTABILITY • FAIRNESS • SECURITY

Americans for Financial Reform
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June 4, 2013

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

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

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

Mr. Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Ms. Mary John Miller
Under Secretary for Domestic Finance
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

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

Dear Sir or Madam:

Americans for Financial Reform (AFR) is submitting this additional comment on the implementation of Section 619 of the Dodd-Frank Act (the 'Volcker Rule') to highlight the implications of the Senate Permanent Subcommittee on Investigations report concerning the JP Morgan 'London Whale' incident (the 'PSI Report').[1]

In several previous letters regarding the Volcker Rule, AFR highlighted the potential for abuse of the hedge exemption and made a number of recommendations for improving it.[2] The November

[1] Americans for Financial Reform is an unprecedented coalition of more than 250 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups.

[2] The initial (February, 2012) joint comment letter submitted by AFR, the AFL-CIO, and the Public Interest Research Group on the Volcker Rule is available at http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2012/02/AFR-Comment-Letter-Volcker-Rule-2-13-122.pdf. A second letter updating comments for further developments was submitted in November 2012, and is available at http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2012/11/AFRVolckerRuleLetterNovember2012.pdf .

2012 letter also discussed some of the specific lessons of the London Whale episode for the Volcker Rule.

However, the PSI Report adds an extraordinary level of detail to our knowledge of this incident. The full case history of the Chief Investment Office's (CIO) management of their credit derivatives portfolio demonstrates beyond doubt the pervasiveness of proprietary trading activities and incentives at our largest Wall Street banks. The failures in risk management documented in this report are the logical outcome of the short-term profit incentives created by proprietary trading, and underline the urgency of completing a strong and effective Volcker Rule. Today, almost three years after the passage of the Dodd Frank Act into law and approaching two years after the initial proposal for the Volcker Rule was released, there is no excuse for further delay.

The revelations in the PSI report also provide valuable insight on ways in which the initial proposed Volcker Rule must be strengthened, and underlines the importance of key elements of the rule which industry commenters have opposed. In particular, it shows that concerns about abuse of the hedge exemption were well founded, and demonstrates the need for various protections called for by AFR and other commenters. These protections include:

- A requirement that trades qualifying for the hedge exemption must hedge a specific asset or position, and also that this relationship is clearly documented on an ongoing basis.

- Ensuring that incentives related to hedging activities are tied to the success of a hedging strategy in mitigating risk, and not to profits generated by the hedge. The supposedly risk-mitigating hedging activity must not become a separate profit center. Employees should be compensated based on success in risk mitigation, not on trading profits that do not function as a hedge.

- Full enforcement of the statutory Volcker Rule prohibition on exposure of the bank to high-risk assets or trading strategies, in this case large and complex derivatives spread trades that can easily conceal proprietary trading.

Below, we briefly discuss these issues.

Hedging specificity and documentation: It is readily evident from the PSI Report that the CIO's synthetic credit portfolio was not in fact a hedge. It did not mitigate risks at the bank and was not specifically tied to any other bank positions. The portfolio did not even provide generalized stress loss protection.[3] Instead, it would have increased JP Morgan's losses in the event that credit market conditions worsened. The portfolio was a proprietary trade; it took a specific view on the market with the intent of making trading profits.

If the CIO had truly been making hedge trades – and had the hedging purpose been enforced through requirements for both explicit specification of the positions being hedged and thorough documentation of hedging relationships and effectiveness -- the losses described in the PSI

[3] See pp. 42-48 and pp. 273-279 of the PSI Report for the evidence demonstrating this.

Report would never have occurred The PSI Report documents the dangers of permitting banks to engage in generalized conceptual 'hedging', and how easily vague conceptual claims of mitigating risk can be used to disguise what are in fact proprietary trades. Likewise, it indicates the value and necessity of requiring hedge relationships to be specified exactly and documented thoroughly.

The Proposed Rule issued by the agencies in 2012 *does* appear to require that trades hedge a specific risk in order to qualify for the hedging exemption, although the exact nature of the relationship required is sometimes too vague. The comment by JP Morgan on the Proposed Rule requests, however, that these requirements be weakened.[4] For example, JP Morgan argues for a generalized exemption for asset-liability management activities that are claimed to be risk reducing even if such activities cannot be linked to specific positions held by the bank. The growth of the synthetic credit portfolio revealed in the PSI report clearly demonstrates the dangers of taking this direction. It underlines again that the agencies need to build on and strengthen the hedge exemption requirements in the Proposed Rule, not weaken them. Enhanced protections needed include more thorough documentation requirements (especially for aggregated hedging), a strengthening of the correlation requirements proposed in the rule, and additional administrative and compensation protections to ensure hedging activities do not become a proprietary profit center.[5]

Hedging Should Not Be a Profit Center: The relationship between hedge trades and the assets to be hedged must be reflected in the incentives offered to hedge traders, and also the accounting and other practices of the desk performing the hedging operations. That is, traders should be compensated for successfully mitigating the risk presented by the assets being hedged, and the success of the hedge trades should be evaluated by a reduction in the volatility of revenues created by the matched hedge-asset pair.

This clearly did not happen in the case of JP Morgan's synthetic credit portfolio. The PSI Report documents that trader compensation was based on "financial gain and risk-taking", instead of effective risk mitigation.[6] (This is of course hardly surprising given that CIO synthetic credit positions were not directly linked to a specific asset, position, or even a clear scenario to be hedged). Reflecting the lack of any clear connection to risk mitigation, the CIO allowed its decision making to be driven by the temporary success of risky proprietary bets. For example, a profit of over $400 million on the bankruptcy of American Airlines apparently led CIO management to significantly expand the size and complexity of the synthetic credit portfolio in early 2012.[7] The outsize influence of a single profitable and unusual trade on the entire management strategy of the bank demonstrates the way in which proprietary trading profits, once permitted, can severely distort risk management in a financial institution.

To prevent such distortions, required management controls for hedging must include careful attention to compensation and reporting practices for hedge positions. The PSI report shows that the evidence of lack of hedging intent and the pursuit of proprietary profits at the Chief

[4] See pp. 23-25 and pp. 54-60. http://www.sec.gov/comments/s7-41-11/s74111-267.pdf
[5] These recommendations are detailed on pp. 33 to 38 of AFR's February, 2012 comment
[6] See pp. 57-59 of the PSI Report.
[7] See pp. 53-54, p. 63 of the PSI Report.

Investment Office were in fact extremely clear and could easily have been discovered by a motivated regulator. It is crucial that in implementing the Volcker Rule, regulators set standards and institutionalize controls that require bank supervisors to look for, identify, and address such proprietary trading disguised as 'hedging'.

Exposure to high-risk assets and trading strategies: Section 13(d)(2) of the Bank Holding Company Act, as added by Section 619 of Dodd-Frank, clearly states that permitted activities under the Volcker rule cannot "result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies". The complex spread trades in credit derivatives engaged in by the CIO – which required enormous positions in order to generate net profits – were clearly high risk.

Unfortunately, the Proposed Rule does not adequately implement the restriction on exposure to high-risk assets or trading strategies. While several such high-risk assets are listed on CFR 68964 of the Proposed Rule, there are no effective controls to either ban exposure to such risks through limitations on permitted activities, or to place additional quantitative limitations and capital requirements on high-risk activities (as is permitted by Section 13(d)(3) of the BHC Act). Regulators should move to either place direct limitations on high-risk assets and trading strategies that may take place under permitted Volcker Rule areas, and /or to place additional capital requirements on such activities.

The February, 2012 AFR comment also argued that the Proposed Rule was particularly vulnerable to abuse in the area of spread or arbitrage trades. Trades that rely on holding simultaneous long and short positions and profiting from the spread between these highly correlated positions are particularly easy to camouflage as 'hedges', and are frequently held for long periods that might exceed the 60 day holding period for scrutiny under the Proposed Rule. Such trades can also be very difficult to effectively risk manage -- they require large gross positions to make a net profit in normal times, and these large gross positions create significant risks if correlations fail to hold. The CIO synthetic credit portfolio was exactly such an arbitrage trade. This underlines the importance of effectively addressing these types of trades in the final rule.

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

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

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

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

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

- The Seminal
- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Partners

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba Ceiba PR

- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA

- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

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