U.S. Commodity Futures Trading Commission
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Bart Chilton
Commissioner

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September 14, 2012

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

Dear Chairman Bernanke:

I am writing in regard to our joint efforts to promulgate regulations prohibiting banks from engaging in proprietary trading. Timely implementation of a strong Volcker Rule by the Federal Reserve Board, the Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Commodity Futures Trading Commission ("CFTC") will go a long way toward furthering the important goals of the Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd/Frank Act"), specifically relating to systemic risk, transparency, and investor protection. In addition to stressing the importance of finalizing the Volcker Rule in a timely fashion, I would like to raise an issue relating to the proposed Rule and its intersection with areas of CFTC interest.

With regard to defining the scope of the "risk-mitigating hedging activity" exemption from the Volcker Rule's general prohibition against proprietary trading, I strongly urge implementation of provisions reflecting the clear intent and goals of the Dodd/Frank Act. A too-expansive definition will significantly undercut the fundamental purposes of the Rule. Moreover, unless we define risk-mitigating hedging activity in this context in a sufficiently targeted fashion, this exemption could provide a dangerous loophole to necessary and appropriate restrictions on banks' trading activity. We have already witnessed in 2008—all too clearly—the disastrous effects of allowing banks to engage in risky speculative transactions.

Our agency has spent decades developing a definition for bona fide hedging, and the CFTC is the expert regulator over the futures and non-security-based swaps markets—the country's largest risk management markets. It is from this vantage point that I urge the promulgation of clear rules designed to ensure that hedges have and retain a risk-retaining nature throughout their lifetime. We should ensure that risk models used to develop risk management programs are robust and not opportunistically or negligently calibrated. Recent market events have demonstrated that even the most sophisticated risk management programs can make erroneous assumptions (for example, by neglecting future liquidity risk in determining the appropriate hedge). Banking entities, particularly large, interconnected banking entities, should be required to present a broad array of risk metrics that demonstrate their continual compliance with the Volcker Rule. The Financial Stability Oversight Committee's 2011 "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds" suggests a number of quantitative metrics that can be utilized by regulators in order to detect and deter proprietary and otherwise potentially risky activities by banking entities. Regulators should continue to work with industry and academic experts to identify and utilize new metrics and indicators that can assist banking entities and their regulators in ensuring compliance with the spirit of the Volcker Rule.

Risk metric reporting aside, if a banking entity's risk management program results in transactions that are not reasonably correlated to risks—that is, gains on "hedges" are greater than the losses on underlying risks—then a strong presumption should be created that the hedge exemption may have been improperly claimed. Risk management programs should not be profit centers for banking entities, and such willful evasion over time in avoidance of the prescribed oversight should be prosecuted with the full force and effect of applicable laws.

In sum, the final rule should encourage prudent risk management and not provide an incentive for banking entities to game the definition of "risk-mitigating hedging activity" to continue proprietary trading and investing under a new guise.

The Volcker Rule protects against the most basic conflicts of interest: prohibiting banks from trading for their own interests ahead of their customers. Prompt promulgation of a strong Rule, enacted with the procedural integrity concomitant with full compliance with the strictures of the Administrative Procedure Act, is a fundamental and necessary reform mandated by Congress in the Dodd/Frank Act. I thank you for your continued guidance and leadership as we proceed to craft and implement the critically important mandates of the Act. I look forward to working jointly to promulgate a rule that promotes the safety and soundness of the American financial system.

Sincerely,

Bart H. Chilton

cc: Vice Chair Janet L. Yellen, Board of Governors of the Federal Reserve System
Elizabeth A. Duke, Board of Governors of the Federal Reserve System
Daniel K. Tarullo, Board of Governors of the Federal Reserve System
Sarah Raskin, Board of Governors of the Federal Reserve System
Jeremy C. Stein, Board of Governors of the Federal Reserve System
Jerome H. Powell, Board of Governors of the Federal Reserve System
Chairman Mary L. Shapiro, SEC
Acting Chairman Martin J. Gruenberg, FDIC

Comptroller of the Currency Thomas J. Curry, OCC
Chairwoman Debbie Stabenow, U.S. Senate Committee on Agriculture, Nutrition and Forestry
Chairman Frank D. Lucas, House Committee on Agriculture
Chairman Tim Johnson, U.S. Senate Committee on Banking, Housing, and Urban Affairs
Chairman Spencer Bachus, House Committee on Financial Services
Senator Jeff Merkley
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