

The Honorable Janet L. Yellen
Chair, Federal Reserve Board of Governors
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Docket Number R-1476

Dear Dr. Yellen:

In response to your invitation for public comment on proposed amendments to Regulation A (Extensions of Credit by Federal Reserve Banks) that would implement sections 1101 and 1103 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). I submit the following commentary and suggestions. Please note, I am writing on my own behalf and based on my own first-person experiences.

After reading the proposal, the only achievable objectives that I can see resulting from these sections of the Act are (1) to punish the Fed for actions it took in 2008; and, (2) to politicise the decision making processes at the Fed. I cannot see how it will underpin a more stable financial system. To the contrary, I do believe that in every way it will foster a less stable, more hostile financial system. A system that will continue to dis-intermediate.

Allowing the Fed to extend support to a particular institution is not about saving a particular institution. It is not about fostering an environment where the rich get richer and no one is ever called to account. It is not about subsidising the creators of heinous, purposeless financial products. It is about whether or not, the Congress wants to sanction the use of collateral calls and shorting bank stock as a means of eliminating competition within the publicly traded financial services industry. From my perspective, the banking industry that the enactment of sections 1101 and 1103 envisages would have the following characteristics:

1. Being aware that there is no longer an independent lender of last resort for individual institutions, publicly traded financial services firms (PTFSF) would be best served by focusing on killing competition whenever possible and not by trying to win business and offering the best services to customers.
2. PTFSFs will limit their exposure to the threats created by syndication, peer lending, repo and commercial paper arrangements. They will only lend to large firms that are cash rich thereby eliminating the need for risk sharing across the system. They will reduce the intermediary impact of their services and limit general market knowledge through reduced communication.
3. Yield curves may experience pressure on front month maturities. Risks of technical issues with debt/loan rolls may erupt into unrecoverable fundamental failures. One can foresee more and not less opportunities for insider trading of equities related to refinancing issues as a result.

The Fed will be authorised to only step in and assist institutions when the entire system ceases to function. And, only when the circumstances are aligned with the objectives of the Treasury. A condition which may or may not be met given the whimsical nature of politics.

To understand why I believe this will be the result of this proposed amendments, one needs to have a different understanding of what happened in 2008. Not an analyst's view. Or, a lawyers. But a witness account.

March 2008. I was a manager of a hedge fund with Bear Stearns as its prime broker. I was seated less than ten blocks from 383 Madison. On the Monday of the last week Bear spent as a stand alone enterprise, I unwound a credit default swap trade. No issues. Wednesday of that week, the unwind proceeds quoted represented a discounted amount to the prevailing cash market value of the trade. I promptly asked for the quote on an offsetting trade and was made a market price. I questioned the asymmetry of the new trade level. I was told that decisions had been made. This was how the treasury desk's liquidity was being handled. Not big T, Treasury. Little t, Bear treasury. And, that it would be better to unwind any loss positions that my fund had facing Bear, as the discounting worked both ways.

I understood that this condition was resulting from particular aspects of market value accounting and performance impairment language embedded in credit product documents. But, the reality was that they were choosing not to honour the agreements as traded. Following the letter but not the spirit. As someone who specialised in the markets of Emerging economies, I was accustom to considering trading conditions that were subject to systemic pressures. But this time and for the first time in my almost decade long trading career, I felt like having a medical emergency. My salesperson dutifully ran through his script. My fund did not have any loss positions facing Bear. In that moment and as gently as I was able to, I tried to tell him that I could not understand how he might think this approach would work. I wanted to hear the upset in his voice. I wanted him to think about what he was saying. But, I did not get what I wanted. He disagreed with equal confidence.

The following Monday, my fund was a client of JP Morgan prime brokerage.

Bear appeared to have three significant businesses. One of which was the prime brokerage business. The prime brokerage business was essentially a deposit taking function. They were acting as custodians. I do not believe any of my peers considered themselves general creditors of prime brokerage firms. Perhaps, some might argue that if you take deposits from hedge funds then you get what you deserve. This is a narrow and ill-informed view. At some point, someone in the upper echelons of Bear must have contemplated their cash liability exposure to the most aggressive type of clients imaginable. After all, such non-traditional deposits are not part of the FDIC regulatory framework.

There is no doubt that a significant amount of malfeasance occurred in the sub-prime/alt-a area. From my perspective, too much blame has been put on the banks and not enough responsibility has been taken the buy side. For a short time, I managed a CDO with an AIG wrap which was successfully unwound by my group in February 2004. It was not easy and

career risk is always a factor. I do believe 2008 was about ethics and experience or lack thereof. Not about financial innovation.

Please consider an alternative approach. If the Fed were there as a lender of last resort for systemically significant financial institutions including those not engaged in traditional deposit taking, perhaps the following might be observed:

1. PTFSFs would operate on a level playing field. They would know that so long as their balance sheets were organised, complete, transparent and understandable that the Fed would be willing, under extreme circumstances, to offer balance sheet support.
2. Incentives for killing off competition through negative selection would be risky. Shorting bank stock in size with the aim of destabilising an institution would be risky. Calling for collateral as a punitive measure would result in the collateral caller appearing as an unworthy counterparty. Clients pulling cash balances for the purposes of reducing default exposure would be reduced.
3. Instruments meant to reduce bank balance sheet risk like CDSs and CDOs could be seen as part of the solution. These instruments, in their basic form, are not complex or beyond comprehension. Sharing risks with others and moving aged inventory over to the buy side where it belongs should be a positive thing. Not a method of mutual destruction. It's simply not possible for a single institution to support some of the largest corporates nor take on large or illiquid positions from asset managers.

I realise that the prevailing view for just about everything is macro, antiseptic, quantitative and anonymous. Over my 12 years as a professional investor, I can say unequivocally, the best opportunities would have been characterised by the antonyms to each of those words.

Firm level. Messy. Qualitative. Personal.

Thank you for the opportunity to comment.

Kind regards,

H. Noel Leonard