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

---

[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

---

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.

---

[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

---

[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.

---

[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

---

[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

---

[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

---

[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

---

[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.

---

[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

---

[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]

---

[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

---

[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

---

[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]

---

[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.

---

[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.

---

[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

---

[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.

---

[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:

---

[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.

---

[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]

---

[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."

---

[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

---

[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.

---

[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

---

[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.

---

[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.

---

[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

---

[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.

---

[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.

---

[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.

---

[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.

---

[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

---

[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

---

[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

---

[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]

---

[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

---

[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?

---

[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?

---

[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

---

[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]

---

[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?

---

[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

---

[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.

---

[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.

---

[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

---

[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

---

[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

---

[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

---

[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.

---

[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

---

[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

---

[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.

---

[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*.

---

[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.

---

[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-

---

[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

---

[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.

---

[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.

---

[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

---

[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

---

[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

---

[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:

---

[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

---

[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.