ANNEXURE A
ANSWERS TO SPECIFIC QUESTIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Why or why not?

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

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

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

Why or why not?

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

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

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

No, for reasons detailed in response to Question 6.

<u>Question 9</u>. Under the proposed rule, would issuers of asset-backed securities be captured by the proposed definition of "banking entity"? If so, are issuers of asset-backed securities within certain asset classes particularly impacted? Are particular types of securitization vehicles (trusts, LLCs, etc.) more likely than others to be included in the definition of banking entity? Should issuers of asset-backed securities be excluded from the proposed definition of "banking entity," and if so, why? How would such an exclusion be consistent with the language and purpose of the statute?

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

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

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

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

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

<u>Question 13</u>. Are the proposed rule's definitions of buy and purchase and sale and sell appropriate? If not, what alternative definitions would be more appropriate? Should any other terms be defined? If so, are there existing definitions in other rules or regulations that could be used in this context? Why would the use of such other definitions be appropriate?

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

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

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

1. Exclusion of Repurchase and Reverse Repurchase Agreements

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

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

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

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

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

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

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

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

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

3. Exclusion of Liquidity Management Programs

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[3] NPR at 68.862.

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

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

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

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

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

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

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

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

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

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

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

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

For further discussion, please see Question 15.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Question 25. How should the proposed trading account definition address arbitrage positions? Should all arbitrage positions be included in the definition of trading account, unless the timing of such profits is long-term and established at the time he arbitrage position is acquired or taken?

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

Please explain in detail, including a discussion of different arbitrage trading strategies and whether subjecting such strategies to the proposed rule would be consistent with the language and purpose of section 13 of the BHC Act.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> This clarifying exclusion is proposed because positions held under a repurchase or reverse repurchase agreement operate in economic substance as a secured loan, and are not based on expected or anticipated movements in asset prices.[6]

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

[6] NPR at 68.862.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[16] CFTC, *supra* note 8.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[20] Acharya, *supra* note 13.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Alternatively, we seek commenter input regarding why repurchase and reverse repurchase arrangements and securities lending transactions do not present the potential for abuse, namely, that a banking entity might attempt to improperly mischaracterize prohibited proprietary trading as activity that qualifies for the proposed exclusions.

We **do** believe that repurchase and reverse repurchase arrangements present *incredible potential for abuse*, and that banking entities are very likely to attempt to improperly mischaracterize proprietary trading as repo or reverse repo agreements. Please see our examples of how a banking entity might do so in our answer to Question 30.

Question 33. Is the proposed clarifying exclusion for liquidity management transactions effective and appropriate? If not, what alternative would be more effective and appropriate, and why? Is the proposed exclusion under- or over-inclusive? Does the proposed clarifying exclusion place sufficient limitations on liquidity management transactions to prevent abuse of the clarifying exclusion? If not, what additional limitations should be specified? Are any of the limitations contained in the proposed rule inappropriate or unnecessary? If so, how could such limitations be eliminated or altered in way that does not permit abuse of the clarifying exclusion?

The proposed clarifying exclusion does not place limitations on liquidity management that are sufficient to prevent abuses and subversion of the Rule. In order to more effectively guard against abuse of this exclusion, we suggest that the Agencies change § _.3(b)(2)(iii)(C) as follows:[30]

> (2) Requires that any transaction contemplated and authorized by the plan be ~~principally~~ *solely* for ~~the purpose of managing the~~ *management of* liquidity of the covered banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;

The Agencies' usage of "principally for the purpose of" improperly dilutes the liquidity management exception. If the Agencies are to allow such an exception, they must require strict compliance, not "principal" compliance. Otherwise, banks would expressly be permitted to conduct openly proprietary trading activities within their liquidity management account, as long as such proprietary activities do not constitute a majority of the activities in that account.

Further, the Agencies should add a reasonableness requirement to § _.3(b)(2)(iii)(C)(3) to ensure that a bank's assumption of what constitute "highly liquid" positions taken for liquidity management purposes has some basis in reality. Otherwise, a bank could avoid all liability during an enforcement action by simply claiming that its proprietary positions, while objectively

[30] This and all suggested changes to the Rule text are also included in Annexure B.

speculative in nature, fall within the liquidity management exemption because the bank considered them "highly liquid" and did not expect to earn appreciable P&L on them at their inception. A subjective expectation is insufficient if it is unreasonable. At one time, Bear Stearns was highly liquid, as were the sovereign debts of Portugal, Italy, Ireland and Greece.

Finally, for the exclusion to be effective, "liquidity management" should be explicitly defined. It is vaguely defined in § _.3(b)(2)(iii)(C)(3) as taking a "highly liquid" position that the bank "does not expect to give rise to" significant P&L. That is why we suggest that the Agencies clarify this definition by making it more explicit, requiring that the "highly liquid," positions be more clearly defined. Failure to clearly define what a "highly liquid" position is will lead to subversion of the rule by way of the liquidity management exclusion.

We also recommend that the Agencies add § _.3(b)(2)(iii)(C)(6):

> (6) Requires that any transaction be conducted at a supervisory level at the banking entity and only with respect to aggregated positions, exposures or holdings.

Question 41. Is the proposed liquidity management exclusion sufficiently clear? If not, why is the exclusion unclear and how should the Agencies clarify the terms of this exclusion?

Please see our suggested revisions to the liquidity management exclusion as described in Question 33.

Question 42. Is the proposed clarifying exclusion for certain positions taken by derivatives clearing organizations and clearing agencies effective and appropriate? If not, what alternative would be more effective and appropriate, and why?

The exclusion for positions taken for registered derivatives clearing organizations or clearing agencies is appropriate. For the sake of clarity, we suggest adding the word "clearing" before the words "securities transactions" to make it absolutely clear that the exclusion is not permitting any securities transactions unless they are directly related to the clearing of such securities. The term "in connection with" clearing derivatives and securities suggests that the only permissible covered positions are the positions that the institution is clearing for its customers. This exclusion therefore would only cover uncleared trades. The Agencies should clarify what covered positions "connected with" clearing qualify for the exclusion.

Question 43. Are any additional clarifying exclusions warranted? If so, what clarifying exclusion, and why?

No further exclusions are warranted, and we would urge the Agencies to push back on any

additional exclusions, given that even the existing exclusions open up potential loopholes for rule evasion (as we have outlined in Question 30).

Question 44. Should the proposed definition exclude any position the market risk of which cannot be hedged by the banking entity in a two-way market?[116]
If so, what would be the basis for concluding that such positions are clearly not within the statutory definition of trading account?

We strongly oppose the suggestion that any position that cannot be hedged in a two-way market be excluded from the proposed definition of covered position, or that any account with such positions be excluded from the definition of "trading account."

Illiquid assets present *more* adverse market risk than other assets, and thus are more likely to lead to conditions that would require depositor bailouts. An illiquid exclusion could exempt entire trading desks that deal with less liquid securities (such as emerging markets or leveraged finance) from regulation, and could incentivize market makers to misrepresent the liquidity of certain assets such that they fall outside of regulation. For example, a bond approaching default will lose liquidity as it gains risk; thus, Greek sovereign bonds are extremely illiquid and would now be outside of the scope of regulation, despite obvious and extreme risks. Although such positions are already excluded from the most recent proposed revisions to the Market Risk Capital Rules (as pointed out in footnote 116 of the NPR),[31] this fact is hardly an effective argument that the NPR should *also* exclude them. If anything, the fact that the Market Risk Capital Rules do not cover such illiquid assets makes it absolutely **imperative** that the final version of this Rule expressly includes all assets, liquid or illiquid. Please see Question 85 for extensive further discussion of the risks of illiquid products.

Question 45. Should the proposed definition include a clarifying exclusion for any position in illiquid assets? If so, what would be the basis for concluding that such positions are clearly not within the statutory definition of trading account? How should "illiquid assets" be defined for these purposes? Should the definition be consistent with the definition given that term in the Board's Conformance Rule under section 13 of the BHC Act (12 CFR 225.180 et seq.)?[117]

The proposed definition should absolutely **not** include a clarifying exclusion for any position in illiquid assets. The Congressional Record shows that the intention of the Volcker Rule was to "prohibit high-risk proprietary trading at banks,"[32] and we can think of no riskier type of proprietary trading than that in illiquid assets.

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[31] Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890, 1912 (proposed Jan. 11, 2011) (excluding from the definition of a covered position any position the material risk elements of which the holder is unable to hedge in a two-way market).
[32] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).

While the statute does provide for an up to five year extension that may be granted by the Board[33] for a banking entity to divest from an "illiquid fund," the statute makes **no special allowances** for illiquid assets as they relate to the trading account. As stated in Question 44, illiquid assets present *more* adverse market risk than other assets, and thus are more likely to lead to conditions that would require depositor bailouts.

Illiquid assets also raise significant risks for investors, because illiquid assets by nature are both difficult to accurately price, and thus difficult to sell. Even if the banking entity is dealing with a highly sophisticated investor, the risks of illiquid assets do not outweigh their benefits, and we cannot fathom a legitimate reason why the Agencies would provide an exclusion for illiquid assets. Such an exclusion would only serve to undermine the very intent of the rulemaking.

Please see Question 85 for further discussion on the risks of illiquid products.

<u>Question 46</u>. Is the proposed rule's definition of covered financial position effective? Is the definition over- or under-inclusive? What alternative approaches might be more effective in light of the language and purpose of section 13 of the BHC Act, and why?

The Proposed Rule's definition of "covered financial position" is imprecise in its delineation of "loans," which are excluded from the scope of the Volcker Rule.[34] The current definition implies that securities, derivatives, and commodity futures are not considered loans. However, this distinction should be made explicit, so that the Proposed Rule makes crystal-clear that any "loan" with the properties of a commodity[35] or security would qualify as a covered financial position. We propose that the definition of loan at § _.2(q) be modified to read as follows:

> (q) Loan means any loan, lease, extension of credit, or secured or unsecured receivable. *A loan shall not mean a position:*
>
> 1. *having the expectation of profits arising from a common enterprise which depends solely on the efforts of a promoter or third party,*[36]
> 2. *in which there is common trading for speculation or investment,*[37]
> 3. *that materially has the characteristics of a commodity, security, or derivative, or*
> 4. *that falls within the scope of § _.3(b)(3)(i)*

[33] 12 U.S.C. § 1851(c)(3)(B) (2011).
[34] Proposed Rule § _.3(b)(3)(ii)(A).
[35] As discussed below, commodities should be included as covered financial positions.
[36] This language derives from *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293 (1946).
[37] This language derives from *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990).

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

For instance, one law firm has suggested that the current version of the Proposed Rule would not restrict a banking entity's ability to use an "intercompany loan" as a means to approximate an "ownership interest" in a securitization SPV.[38] That is, the Volcker Rule's restrictions on "ownership interest" can be evaded by structuring an interest in an SPV as an intercompany "loan" and not ownership *per se*.

In a more straightforward securitization, the banking entity has an ownership interest in the SPV, and therefore gains risk exposure to the asset pool underlying the transaction. The same result can be achieved by using an intercompany loan, such that the bank loans money to the SPV, and is repaid its money by the SPV based only on the performance of the underlying asset pool.[39] In either scenario, the banking entity's income stream is dependent on the timely and regular flow of funds from the underlying assets. However, the latter structure, ostensibly a "loan," would fall outside the purview of the Proposed Rule in its current form. Our proposed modification at § _.2(q)(1) or (2) would foreclose a banking entity's ability to evade the Volcker Rule's restrictions by using so-called loans as conduits for proprietary positions.

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

<u>Question 47</u>. Are there definitions in other rules or regulations that might inform the proposed definition of covered financial position? If so, what rule or regulation? How should that approach be incorporated into the proposed definition? Why would that approach be more appropriate?

For further discussion, please see Question 50.

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

[39] *See* Vinod Kothari. Covered Bonds in Asia 9-10 (1st ed. 2006), *available at* http://www.vinodkothari.com/Covered%20Bonds%20in%20Asia.pdf. In such a structure, the loan repayment obligations of the banking entity can be tailored to match the debt profile in the SPV's asset-backed securities. *See* Vinod Kothari, Securitization: The Financial Instrument of the Future 348 (1st ed. 2006).

<u>Question 49</u>. The proposal would apply to long, short, synthetic, or other positions in one of the listed categories of financial instruments. Does this language adequately describe the type of positions that are intended to fall within the proposed definition of covered financial position? If not, why not? Are there different or additional concepts that should be specified in this context? Please explain.

The Agencies should promote greater definitional identity between the concept of "covered financial position" in the Volcker Rule and the "covered position" standard used in the Market Risk Capital Rule. At present, the two standards are "similar," but remain materially dissimilar in significant ways (For further discussion, please see Question 50). The Proposed Rule does not explain why the same standard is not utilized in both contexts.

<u>Question 50</u>. Should the Agencies expand the scope of covered financial positions to include other transactions, such as spot commodities or foreign exchange or currency, or certain subsets of transaction (e.g., spot commodities or foreign exchange or currency traded on a high-frequency basis)? If so, which instruments and why?

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

> any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.[40]

Admittedly, Section 619(h)(4) does not explicitly include spot commodities, instead referring to commodity futures and forwards. Nevertheless, the same section grants the Agencies the authority to bring commodities into the Volcker Rule's ambit. The Agencies should utilize this authority as it appears that the exclusion of the word "commodity" from the statute was an oversight. In the Congressional Record, Senator Merkley stated that the intent behind Section 619 was to define proprietary trading to cover "**a wide range** of financial instruments, including securities, **commodities**, futures, options, derivatives, and **any similar financial instruments**."[41] The expansive breadth of this language also militates in favor of the inclusion of foreign exchange and currency positions. Accordingly, we recommend that the Agencies entirely remove Proposed Rule § _.3(b)(3)(ii)(B) and (C).

This removal is also necessary because the definition of "covered financial position" under the Volcker Rule does not match the definition of "covered position" under the Market Risk Capital

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[40] 12 U.S.C. § 1851(h)(4).
[41] 156 Cong. Rec. S5895 (daily ed. July 15. 2010) (statement of Sen. Levin)(emphases added).

Rule, which explicitly includes all positions in a trading account, "and all foreign exchange and commodity positions, whether or not they are in the trading account."[42] As noted elsewhere in the Proposed Rule, the Market Risk Capital Rules have a high degree of relevance as to what is and is not covered by the Volcker Rule, specifically with respect to the definition of "trading account." Thus, the Agencies create undue ambiguity by imposing two different standards in related rules. A decision by an administrative agency that is based on a rationale that is internally inconsistent or incoherent will be set aside.[43]

Question 51. What factors should the Agencies consider in deciding whether to extend the scope of the proprietary trading restriction to other financial instruments under the authority granted in section 13(h)(4) of the BHC Act?

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

Question 60. Is the manner in which the proposed definition of derivative excludes any transaction that the CFTC or SEC exclude by joint regulation, interpretation, guidance, or other action from the definition of "swap" or "security-based swap" effective? If not, what alternative approach would be more appropriate? Should such exclusions be restated in the proposed rule's definition? If so, why?

The Proposed Rule references standards (definitions of "swap" or "security-based swap") that themselves are still at the proposed rule stage under a separate notice of rulemaking. The final version of these definitions may have additional exclusions that we are not aware of at this time. Thus, the public may not have an adequate opportunity to respond to material aspects of this Proposed Rule if the final definitions of "swap" or "security-based swap" are different from what has already been proposed. We recommend that the Agencies state the exact language of these terms in this Proposed Rule rather than referring to inchoate definitions from a separate proposed rule.

Question 61. Is the proposed rule's definition of loan appropriate? If not, what alternative definition would be more appropriate? Should the definition of "loan" exclude a security? Should other types of traditional banking products be included in the definition of "loan"? If so, why?

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[42] Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. at 1892.

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

For further discussion, please see Question 46.

<u>Question 65</u>. Are the seven requirements included in the underwriting exemption effective? Is the application of each requirement to potential transactions sufficiently clear? Should any of the requirements be changed or eliminated? Should other requirements be added in order to better provide an exemption that is not susceptible to abuse through the taking of speculative, proprietary positions in the context of, or mischaracterized as, underwriting? Alternatively, are any of the proposed requirements inappropriately restrictive in that they would be inconsistent with the statutory exemption for certain underwriting activities? If so, how?

The Agencies have transgressed their delegated authority by allowing the underwriting exemption in the Volcker Rule to include private placements. Section 619(d)(1)(B) permits certain "underwriting . . . activities." Not coincidentally, this section is bereft of any mention of "private placement activities" or "placement agent." In issuing implementing regulations, an administrative agency must give effect to the unambiguously expressed intent of Congress.[44]

Under the basic securities law definition of the term, an "underwriter" includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security."[45] Such a person is required to file a registration statement before offering to sell a security as part of a primary distribution.[46] Conversely, if a person is legally exempt from the registration statement requirement, that person cannot be an "underwriter" under Section 2(a)(11) of the Securities Act of 1933 ("'33 Act"). For example, a placement agent relying on the Rule 144 exemption is not considered an "underwriter."[47] Thus, the Section 2(a)(11) definition of underwriter would require that any underwriting activities permitted under the Volcker Rule be in connection with regulated securities.

Much to our chagrin, the Agencies have found a way to bypass this basic stricture. In defining the term "underwriter" in the Proposed Rule, the Agencies curiously rely on the definition of that term in Regulation M, instead of the more obvious and basic definition found at Section 2(a)(11) of the '33 Act.[48] Section 2(a)(11) has close to a century of case law and interpretive guidance

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[44] *Chevron U.S.A. Ins. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984).
[45] 15 U.S.C. § 80b-2(a)(11) (2011).
[46] 15 U.S.C. § 80b-4(1), 5(c).
[47] Preliminary Note to Rule 144. 17 C.F.R. § 230.144 (2012).
[48] *Compare* 17 C.F.R. § 242.100 (2011) (Regulation M definition) ("Underwriter means a person who has agreed with an issuer or selling security holder: (1) to purchase securities for distribution; or (2) to distribute securities for or on behalf of such issuer or selling security holder; or (3) to manage or supervise a distribution of securities for or on behalf of such issuer or selling security holder."). *with* 15 U.S.C.. § 77b(11) (2011) (Section 2(a)(11) definition of underwriter) ("The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security. or participates or has a direct or

supporting it, and it is therefore more appropriate than the Regulation M definition. Further, as noted above, nothing in Section 619 or the Congressional Record suggests that Congress wanted "underwriter" to be defined as per Regulation M. Moreover, Regulation M is not a good definitional source because the underlying purpose behind it conflicts with the underlying purpose behind the Volcker Rule. Regulation M was designed to prevent manipulation and other activities that could artificially influence the market for an offered security.[49] Thus, a broad interpretation of the term "underwriter" was naturally necessary in that context to promote greater investor protection and market stability. However, using the same broad interpretation of "underwriter" in the context of Section 619 would actually undermine investor protection, as it would increase the size of the underwriting loophole through which covered banking entities could conduct risky proprietary trading activities.

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

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

> § _.4(a)(2)(ii): The covered financial position is a **registered** security;
> § _.4(a)(3): Definition of distribution. For purposes of paragraph (a) of this section, a distribution of securities means an offering of securities~~, whether or not subject to registration under the Securities Act,~~ that is distinguished from ordinary

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indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.").

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

trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.

§ _.4(a)(4): Definition of underwriter. For purposes of paragraph (a) of this section, underwriter means:

(i) A person who has agreed with an issuer of securities or selling security holder:

(A) To purchase **registered** securities for distribution;

(B) To engage in a distribution of **registered** securities for or on behalf of such issuer or selling security holder; or

(C) To manage a distribution of **registered** securities for or on behalf of such issuer or selling security holder; and

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

Question 68. What increased costs, if any, would underwriters incur to satisfy the seven proposed requirements of the underwriting exemption? Would underwriters pass the increased costs onto issuers, selling security holders, or their customers in connection with qualifying for the proposed exemption?

As discussed more fully below in the Cost and Benefits section, any increased costs borne by underwriters are entirely justified given the benefits that a vigorous interpretation of the Volcker Rule would have on depositors, banking entities, the banking market, investors and the global economy as a whole.

Question 72. Is the proposed definition of "underwriter" appropriate, or over- or under-inclusive in this context? Would an alternative definition, such as the statutory definition of "underwriter" under the Securities Act, better identify persons intended to be covered by the proposed definition? If so, why?

For further discussion, please see Question 65.

Question 73. How accurately can a banking entity engaging in underwriting predict the near-term demands of clients, customers, and counterparties with respect to an offering? How can principal risk that is retained in connection with underwriting activities to support near-term client demand be distinguished from positions taken for speculative purposes?

For further discussion, please see Question 75.

<u>Question 74</u>. Is the requirement that the underwriting activities of a banking entity relying on the underwriting exemption be designed to generate revenues primarily from fees, commissions, underwriting spreads or similar income effective? If not, how should the requirement be changed? Does the requirement appropriately capture the type and nature of revenues typically generated by underwriting activities? Is any further clarification or additional guidance necessary?

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

To ameliorate this practical deficiency, we suggest that the Agencies *require automatic disgorgement of any profits arising from appreciation in the value of covered financial positions in connection with underwriting activities*, regardless of whether those profits were intended or not. If the Agencies are serious about requiring that fees be based only on commissions and spreads, they should be willing to enforce that requirement through disgorgement. Any profits that banks earn from capital gains could be disgorged to the affected client (e.g., the issuer of the security), distributed pro rata to the bank's depositors, or paid to the U.S. Treasury as a penalty.

A simple disgorgement standard would obviate much of the complexity that is inherent to the current implementation of the underwriting exemption. For example, the Agencies would no longer need to distinguish between activities supporting near-term client demand from activity taken for speculative purposes. **If a bank were subject to disgorgement, it would no longer have any financial incentive to undertake speculative positions**, given that its compensation would be capped at earned commissions. Similarly, the Agencies would not need to concern themselves with winnowing risk-rewarding compensation arrangements from safe ones. If a banking entity could no longer keep gains from principal risks, it would not create incentives for its employees to take such risks. At most, banks would compensate employees for pursuing underwriting in markets with high spreads (i.e., currently illiquid markets). This result would create strong incentives for increased capitalization in illiquid markets, which should allay some of the concerns that banks have expressed about the Volcker Rule's impact on "liquidity." Indeed, we interpret every comment letter lauding the virtues of market "liquidity"[50] as a further vindication of an explicit disgorgement requirement.

<u>Question 75</u>. Is the requirement that the compensation arrangements of persons performing underwriting activities at a banking entity be designed not to reward proprietary risk-taking effective? If not, how should the requirement be changed? Are

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

there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted underwriting activity? Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?

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

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

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

Accordingly, we recommend the following revisions:

> § _.4(a)(vi) The underwriting activities of the covered banking entity ~~are designed to~~ generate revenues ~~primarily~~ **solely** from fees, commissions, underwriting spreads or other income not attributable to:
>
> (A) Appreciation in the value of covered financial positions related to such activities; or
>
> (B) The hedging of covered financial positions related to such activities; and

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

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

Question 77. Does the proposed underwriting exemption appropriately accommodate private placements? If not, what changes are necessary to do so?

For further discussion, please see Question 65.

Question 78. The creation, offer and sale of certain structured securities such as trust preferred securities or tender option bonds, among others, may involve the purchase of another security and repackaging of that security through an intermediate entity. Should the sale of the security by a banking entity to an intermediate entity as part of the creation of the structured security be permitted under one of the exemptions to the prohibition on proprietary trading currently included in the proposed rule (e.g., underwriting or market making)? Why or why not? For purposes of determining whether an exemption is available under these circumstances, should gain on sale resulting from the sale of the purchased security to the intermediate entity as part of the creation of the structured security be considered a relevant factor? Why or why not? What other factors should be considered in connection with the creation of the structured securities and why? Would the analysis be different if the banking entity acquired and retained the security to be sold to the intermediate entity as part of the creation of the structured securities as part of its underwriting of the underlying security? Why or why not?

The Proposed Rule already contains numerous exemptions for permitted proprietary trading. One such exemption, for riskless principal positions taken on behalf of customers, could be utilized for the purpose described in this Question. No separate exclusion is necessary or warranted.

Structured securities of the type described are created for the benefit of the banking entity, not the intermediate entity. Thus, the bank will invariably receive some interest from its role as conveyor of securities to the intermediate entity. Pursuant to Section 619, that interest must not approximate a proprietary position. If the Agencies create an additional exclusion for the conveyance of securities to intermediate entities, banking entities could utilize that exclusion to gain exposure to proprietary positions by buying and selling risky securities to "bad bank" intermediate entities. Furthermore, if the intermediate entity does not qualify as an "affiliate," it could be used by the banking entity as an indirect vehicle to effect proprietary trades.

<u>Question 79</u>. We seek comment on the application of the proposed exemption to a banking entity retaining a portion of an underwriting. Please discuss whether or not firms frequently retain securities in connection with a distribution in which the firm is acting as underwriter. Please identify the types of offerings in which this may be done (e.g., fixed income offerings, securitized products, etc.). Please identify and discuss any circumstances which can contribute to the decision regarding whether or not to retain a portion of an offering. Please describe the treatment of retained securities (e.g., the time period of retention, the type of account in which securities are retained, the potential disposition of the securities). Please discuss whether or not the retention is documented and, if so, how. Should the Agencies require disclosure of securities retained in connection with underwritings? Should the Agencies require specific documentation to demonstrate that the retained portion is connected to an underwriting pursuant to the proposed rule? If so, what kind of documentation should be required? Please discuss how you believe retention should be addressed under the proposal.

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

A bona fide underwriter's objective is to push the issuer's securities out to market, and not to retain those securities for speculation, investment or price manipulation. A banking entity falls short of the objectives behind the Volcker Rule to the extent that it has unsold allotments in its banking book in connection with an underwriting. Underwriters are required to conduct extensive due diligence, so they can reasonably be expected to forecast the demand for a particular offering before actually underwriting it. Consequently, the Agencies can fairly require that a bona fide underwriter have little or no unsold allotments. Accordingly, we recommend that the Agencies add an additional factor to the current seven-part test for underwriting, under which the existence of a "substantial" unsold or retained allotment would be an indication of proprietary trading. The term "substantial" would depend on the circumstances of a particular offering. This factor is similar to § _.4(a)(2)(v), which focuses on near-term demands of customers. However, an "unsold allotment" factor would shift the inquiry from something subjective (demands of customers) to a more objective, quantifiable figure (the number of unsold shares in an issue).

Unsold allotments present a conflict of interest vis-à-vis customers. Section 619(d)(1)(B) stipulates that any underwriting activities must be "designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties." Issuers that hire underwriters expect that the underwriter will promote liquidity in the issuer's securities by selling them into the market. Thus, a potential conflict of interest exists whenever a banking entity retains unsold allotments pursuant to an underwriting. Such a conflict would undercut the

banking entity's underwriting exemption by operation of the limitation contained in Section 619(d)(2)(A)(i).

Impermissible conflicts of interest can also arise where allotments of underwritten securities are retained for the purpose of "spinning,"[51] instead of being sold in the market. The practice of spinning allows underwriter insiders to profit from IPO price gains, to the detriment of investors and the issuer. The risk of spinning is more pronounced in unregistered offerings, which have less securities law protection. Notably, spinning is only possible where an underwriter does not sell all of its allotment into the market. Thus, the retention of securities should be viewed by the Agencies with a high degree of scrutiny.

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

Question 80. Is the proposed rule's approach to implementing the exemption for permitted market making-related activities (i) appropriate and (ii) likely to be effective? If not, what alternative approach would be more appropriate or effective?

As a group that includes many former banking industry employees, we recognize and appreciate the complexity of the industry that the Agencies are charged with regulating. It is clear that the Agencies reasonably assumed that this very complicated problem would necessitate a very complicated solution, but unfortunately the end product may be rendered impotent by the excessively broad scope of its exemptions and allowances.

One thing that was overwhelmingly clear to us throughout the Proposed Rule is that many of the current proprietary trading practices can easily continue after implementation of this Rule by enacting only the most superficial changes. It is with this in mind that we conclude that the Rule's approach to the market making exemption may be appropriate, but is very unlikely to be effective.

It is disingenuous to presume that market makers are unable to distinguish between "bona fide" market making activity and proprietary trading. Despite the implication in the extensive

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

explanations provided in this Rule, any competent trader certainly "knows it when he sees it"[52] with respect to proprietary trading. We propose two general guidelines that could potentially encourage compliance more easily and with far fewer resources required by the Agencies.

1. Disgorgement of all Trading Profits

As has been noted in a variety of venues with respect to this legislation, market making is a "customer service."[53] Typically, customer services are not meant to be profit centers for a business, they are cost centers necessary to facilitate other profitable businesses. Market making, however, is not a service that fits this definition.

In the absence of proprietary profits, it is unclear if market making, especially in illiquid markets, is an inherently profitable business. This conclusion is intuitive as well. By definition, market makers are expected to be selling when customers are buying, and vice versa. Transaction costs and advantageous market information allow for efficient risk mitigation, such that a market maker can constantly renew his capacity to intermediate. If this job is performed constantly and flawlessly, he will reap only a modest monetary profit but tremendous gains in customer satisfaction.

It is impossible, then, to view large gains or losses as anything other than the result of improper risk taking or negligent hedging within a market making book. Requiring banking entities to disgorge the profits from market making operations would simply and elegantly remove any element of proprietary speculation, since there would be no incentive to do so. Such incentive alignment would do much more to curb improper activity than would any lengthy legislation.

We have added disgorgement of trading profits to the list of criteria required for the market making exemption in *Annexure B*.

Please see Question 192 for further discussion of this issue.

2. Strict Penalties for Violation

Encouraging the practical use of traders' own intuitions and understanding of what is and is not a

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[52] Gary Antsey, *What Experienced Practitioners Know*, Financial Times, Dec. 22, 2011, *available at* http://www.ft.com/intl/cms/s/0/2e3fbbb8-2a5c-11e1-8f04-00144feabdc0.html. ("Paul Volcker is correct in his assertion that proprietary trading is like pornography inasmuch as he 'knows it when he sees it.'").

[53] 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("Market making is a customer service whereby a firm assists its customers by providing two-sided markets for speedy acquisition or disposition of certain financial instruments. Done properly, it is not a speculative enterprise, and revenues for the firm should largely arise from the provision of credit provided, and not from the capital gain earned on the change in the price of instruments held in the firm's accounts.").

proprietary risk will be the most efficient way to cut down regulatory complexity in this rule. We submit the following truths for the Agencies' consideration:

- Traders are acutely and constantly aware of which of their trades are in fact customer serving.

- Demonstrating this for any particular trade is simple, and evidence should not be difficult to provide–even within the limits of current operational regimes within most banking entities.

- Taking proprietary risks has significant benefits and few downsides for individual traders, and so proprietary risk-taking will continue to be attractive despite the implementation of this Rule.

In theory, these upside/downsides should be controlled and equated by firms' attempts to manage risk, but for many reasons this has never been the case. It is our opinion that **addressing this risk/reward disparity is precisely where regulators are most necessary and can be most effective in exacting real, meaningful changes**. If traders and managers are held personally responsible for violations of this Rule by facing fines and criminal penalties, a culture of voluntary compliance would emerge organically.

For further discussion, please see Question 214.

Question 81. Does the proposed multi-faceted approach appropriately take into account and address the challenges associated with differentiating prohibited proprietary trading from permitted market making-related activities? Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

This comprehensive approach to adequately differentiating between the two kinds of trading activity is laudable. The goal of inhibiting excessive risk taking without stifling the engine of healthy markets requires thoughtful negotiation between safety and growth, and will result in a delicate balance. It is clear that absolute results are impractical, and perhaps the best outcome is one where Team Safety (Regulators) and Team Growth (Banks) both feel equally undermined by the final result.

As it is currently written, we see that the Agencies' proposed multi-faceted approach has endeavored to use every tool at their disposal to assist in this differentiation, and we are supportive of this. The precise implementation of these tools, however, needs a tremendous amount of refining to be effective. Our specific concerns will be addressed in the following questions.

7 Market Making Criteria: We provide a more detailed discussion of the list of criteria in Question 87, but in general we find the criteria to be necessary, but not sufficient. Most troubling are the extremely imprecise definitions and indicia of market making in liquid and illiquid markets. The many broad allowances for inconsistent activity come across as a list of possible disguises for proprietary trades, and the implication is that the Agencies do not intend to be scrupulous here in their enforcement. We sincerely hope that this was not the intention, and is not the case. This particular issue of differentiating prohibited trading from permitted activity is one of the most central to this Rule and it is imperative that the covered banking entities, and the Regulatory Agencies, take it seriously.

Consistency with the Commentary: The Commentary is appropriate for only the most liquid and transparent markets (i.e., listed equities, treasuries), and fails to accurately describe market making in most illiquid or OTC markets. This general reliance on highly liquid markets as a model for all trading activities is found throughout the Rule. We find this particularly troubling, given that such markets were not considered to be contributors to the most recent crisis, and are not expected to become risk factors in the future. Illiquid markets were and continue to be havens of risky and irresponsible activity, yet they are largely forgiven throughout this rule. We have submitted an alternative Market Making Commentary with this letter, at *Annexure C*, which reflects our suggested changes.

Reporting Requirements: The quantitative measurements are an important reporting requirement, but leave ample room to misrepresent overall activities, bypass requirements, and explain away inconsistencies. This issue is discussed further in its relevant section.

A straightforward addition to this approach that could ensure a tremendous amount of voluntary compliance is **an explicit prohibitive penalty for violation**. We are concerned that the Proposed Rule's multi-faceted approach mirrors that recommended by the FSOC Study, **except for** the requirement for enforcement procedures:

> The study recommends Agencies consider a four-part supervisory framework to assist banking entities and Agencies in distinguishing prohibited proprietary trading from permitted activities, consisting of:
>
> 1. Programmatic compliance regime;
> 2. Analysis and reporting quantitative metrics;
> 3. Supervisory review and oversight; and
> 4. **Enforcement procedures for violations**[54]

[54] Financial Stability Oversight Council, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds at 15 (Jan. 18, 2011) (emphasis added), *available at*

Although the complicated guidelines of the Proposed Rule imply otherwise, it is unrealistic to presume that traders cannot distinguish between market making and proprietary trading. Further clarity is unnecessary if the valuable intuition of the traders is properly incentivized. It is worth noting that the FSOC Study **repeatedly**[55] advises the clear and explicit use of penalties as a core component of this legislation, but specific discussion of penalties is largely absent from the Proposed Rule text.

An additional consideration that goes unaddressed throughout the Proposed Rule, and is of particular concern regarding the complex multi-faced approach, is the tremendous amount of resources required *by the Agencies* to effectively administer such a complicated system. It is reasonable to assume that the Agencies will need to find ways to devote such resources to ensure proper implementation of this multi-faceted approach, or else the Rule will proceed unmonitored, unenforced, and useless.

Question 82. Does the proposed multi-faceted approach provide banking entities and market participants with sufficient clarity regarding what constitutes permitted market making-related activities? If not, how could greater clarity be provided?

What we gleaned from the multi-faceted approach is as follows: In those instances where an explicit line between permitted and prohibited activity can be drawn, the Agencies have done so. Where such a differentiation is more complicated, the Agencies will deem most activity to be permitted. We are troubled by the fundamental equation of "what is permitted" to "what will be enforced." The latter is sufficiently clear. The former, however, remains overwhelmingly obscured. A glaring example of this is in the treatment of gains from capturing bid/offer spreads in illiquid markets. We provide a basic example to illustrate some of the important failings in the practical implementation of this revenue requirement:

> *A market maker in an illiquid bond provides regular indicative markets that are 0.25pt wide, which is seen as standard bid/offer size for this bond. In a given day he conducts 10 trades: 5 buys and 5 sells, all of standard equal size. 3 of these trades were conducted with clients, and 7 through an inter-dealer broker. Other*

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http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20619%20study%20final%201%2018%2011%20rg.pdf [hereinafter FSOC Study].

[55] *Id.* at 3 ("Require divestiture of impermissible proprietary trading positions and impose penalties when warranted."). *See also id.* at 6 ("[Existing remedies] should not preclude Agencies from considering other potential supervisory or enforcement actions such as increased oversight, reductions in risk limits, increased capital charges, or monetary penalties. Also, it should not insulate proprietary trading from other applicable provisions of law."); *id.* at 32 ("Banking entities should be subject to strong supervisory consequences and penalties for violations, which should include termination of the activity or disposal of the investment, and other legal sanctions as appropriate"); *id.* at 41 ("[T]here should be strong penalties for traders or salespeople that make a practice of mischaracterizing trader-initiated trades as customer-initiated trades.").

trades in this bond occur throughout the day away from this market maker. On average, the trader sold the bonds 1pt higher than he bought them.

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

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

The addition of "bright-line" prohibitions of risky activity within the market making exemption is **crucial**. If legitimate market making activities of a security requires, or otherwise causes, a banking entity to assume large illiquid positions (as the industry claims it must),[56] and those positions cause the banking entity to endure significant losses (as they famously and repeatedly have done), this rule would be considered a failure.

Question 83. What impact will the proposed multi-faceted approach have on the market making-related services that a banking entity provides to its customers?

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

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

How will the proposed approach impact market participants who use the services of market makers?

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

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

If it is the case that certain businesses prove to be unviable within covered banking entities following implementation of this Rule, a period of adjustment will be uncomfortable but necessary throughout the industry. One obvious aspect of this adaptation will be the emergence of new firms that seek to capture the profitable intermediary business that is exited by banking entities. In consideration of the necessary growing pains associated with such adaptation, it should be noted that **many firms are already well positioned and eager to enter or expand within this business**, and such firms should be expected to ease such transition.[57] The customers of banking entities will face the burden of navigating a new pool of service-providers as roles readjust throughout the market. Their relationships with covered banking entities, however, will improve dramatically as conflicts of interest are eliminated and true customer service is prioritized.

How will the approach impact the capital markets at large, and in particular the liquidity, efficiency and price transparency of capital markets?

It has become common understanding in the years since the onset of the financial crisis that the single most important contributor to ensuring functional liquidity in markets is a healthy and safe banking system. This Proposed Rule, despite its shortcomings, will do more to promote the

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

safety and soundness of the covered banking entities and banking system at large than any other piece of legislation since Glass-Steagall.

The idea put forth by industry lobbyists and trade groups, that the removal of a government subsidy within a segment of market makers will cause serious and permanent market-wide reductions in liquidity,[58] defies both common sense and the foundations of free-market capitalism. We urge the Agencies to keep sight of the fact that a proprietary trading platform embedded within a client-intermediation business is extremely profitable, and those firms outside the scope of this legislation will happily act to fill any holes that are created by this approach. The market will move to provide the liquidity it needs, without regard for the federal backing of the providers.

We do not believe that the NPR will have a significant effect on price transparency or efficiency. Concrete changes could be made to promote efficiency and transparency, such as requiring all standard products to trade on exchanges, requiring real-time public reporting of price and transaction data, and re-defining "bona-fide" market making such that it mandates continuous *tradable* quotations on a multilateral electronic trading facility. These changes would have a tremendous impact on transparency and efficiency throughout capital markets. Merely restricting proprietary trading in covered banking entities, however, will not.

If any of these impacts are positive, how can they be amplified? If any of these impacts are negative, how can they be mitigated?

Our position, as described above, is that the Proposed Rule will have little lasting adverse impact on liquidity, transparency, or efficiency. Consistent with that reasoning, we see no benefit, and meaningful public risk, in retaining *any* trading operations within federally backstopped institutions, unless they are trading strictly on behalf of customers.

Would the proposed rule's prohibition on proprietary trading and exemption for market making-related activity reduce incentives or opportunities for banking entities to trade against customers, as opposed to trading on behalf of customers? If so, please discuss the benefits arising from such reduced incentives or opportunities.

We see the alignment of interests of market makers and their clients as one of the most important effects of the Proposed Rule. The current market structure, wherein proprietary trading market-maker hybrids are presumed to provide an unencumbered "service" to customers, is clearly rife with conflicts of interest. In all markets, market makers are provided with valuable market flow information in exchange for acting as an on-demand counterparty. The understanding is that a good market maker will make use of that information to efficiently manage client flow, such that he can sell what he buys for a nominal profit and re-up his capacity to take on his clients' trades.

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[58] *See, e.g.*, SIFMA & Oliver Wyman, *supra* note 56.

When a market maker is also acting as a proprietary trader, however, this flow information (i.e., the size and timing of his clients' investments) exists as the basis for his proprietary strategy. What this implies, and certainly what we have experienced in practice, is that ***a market maker effectively profits from proprietarily front-running his clients***. Clients know this, but banks have long colluded to ensure the continuation of a system with few alternatives for intermediation.

Question 84. What burden will the proposed multi-faceted approach have on banking entities, their customers, and other market participants?

The largest and most vocally-opposed effect on banking entities will be the reduction in highly-profitable proprietary trading within their market making businesses. This is a necessary consequence, and we feel it unworthy of reconciliation in the context of this Rule's intent. Senator Conrad put the costs of implementing this legislation into perspective in his explanation to Congress: "[t]his bill is an insurance policy against an expensive future taxpayer bailout."[59]

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

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

The customers of banking entities will face the burden of navigating a new pool of service-providers as roles readjust throughout the market. Their relationships with covered banking entities, however, will improve dramatically as conflicts of interest are eliminated and true customer service is prioritized.

Other market participants, particularly those who seek to inherit profitable businesses previously monopolized by covered banking entities, will experience considerable benefits[60] due to the proposed approach. We have found little evidence that the implementation of this Rule in

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[59] 156 Cong. Rec. S5893 (daily ed. July 15, 2010) (statement of Sen. Conrad).

[60] Marcinek & Schatzker, *supra* note 57 (quoting Howard Lutnick, CEO of inter-dealer broker BGC Partners as saying that "Dodd-Frank will either be beneficial, or violently beneficial for BGC Partners, I'm just not sure which one").

general, or this approach specifically, will have any permanent or adverse effects on financial markets at large.

For further discussion, please see Question 83.

How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?

As stated above, this burden is the effect of an appropriate reallocation of costs and services within the market, and should not be minimized or eliminated.

Question 85. Are there particular asset classes that raise special concerns in the context of market making-related activity that should be considered in connection with the proposed market-making exemption? If so, what asset class(es) and concern(s), and how should the concerns be addressed in the proposed exemption?

Over-the-counter (OTC) markets, complex derivatives, and other illiquid markets present various important concerns. We have taken much time and care in addressing the various challenges in implementing this rule in illiquid and opaque markets, and these thoughts are presented below. However, we have concluded that a meaningful interpretation of the intentions of the statute would prohibit *all* activities in these instruments.

Risky products, such as illiquid bonds, credit default swaps (CDS), and other complex derivatives, were precisely those instruments that contributed to the financial crisis in 2008, and those that this legislation sought to expel from federally-backstopped banking entities. We find it disingenuous to suggest that this was not commonly understood by the banking entities, the regulators, and the public long before this Proposed Rule was drafted. Senator Merkley explicitly addressed the prohibition of market making in both credit default swaps and other "high risk instruments." He explicitly calls out credit default swaps as a high-risk instrument:

> The reality was that Goldman Sachs was creating new securities for sale to clients and building large speculative positions in high-risk instruments, including credit default swaps.[61]

Sen. Merkley also makes clear that any trading of high-risk assets is not to be permitted whether or not they qualify for the market-making exemption:

> Barring high-risk strategies may be particularly critical when policing market-making-related and hedging activities, as well as trading otherwise permitted under subparagraph (d)(1)(A). In this context, however, it is irrelevant whether or

[61] 156 Cong. Rec. S5894 (daily ed. July 15. 2010) (statement of Sen. Merkley).

> not a firm provides market liquidity: high-risk assets and high-risk trading strategies are never permitted.[62]

We are troubled by the ways in which this very clear explanation was ignored throughout this Proposed Rule. Credit default swaps are hardly among the riskiest securities traded on market making desks, which indicates that the scope of the Senator's statement is far reaching. We see no reasonable way to implicitly allow for market making in CDS, or similar products, anywhere in this Proposed Rule.

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

> Testimony by Goldman Sachs Chairman Lloyd Blankfein and other Goldman executives during a hearing before the Permanent Subcommittee on Investigations seemed to suggest that *any time the firm created a new mortgage related security and began soliciting clients to buy it, the firm was 'making a market' for the security.*[63]

The senator rejected the implication that a one-sided market (a market with only a bid or an ask) is a legitimate one, with respect to market making: "one-sided marketing or selling securities is not equivalent to providing a two-sided market for clients buying and selling securities."[64] This speaks both to bespoke structured products, which markets are "made" by creating and marketing non-standardized derivatives to clients, as well as standardized instruments that trade infrequently and lack consistent market support. **The nature of all illiquid markets is that they exist primarily as one-sided markets** at any point in time. OTC markets operate with *no requirement* that a market maker provides realistic and tradable prices in these products at all times. Nor are there systems that would allow the Agencies to monitor or confirm such activity. Despite the Senator's clear declaration of the statute's intent, the Supplementary Information of this Proposed Rule explicitly allows for one-sided markets in illiquid products by including them in the indicia of bona fide market making:

> With respect to securities, regularly purchasing covered financial positions from, **or** selling the positions to, clients, customers, or counterparties in the secondary market.[65]

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[62] *Id.*
[63] *Id.* at S5896 (emphasis added).
[64] *Id.*
[65] NPR at 68,871 (emphasis added).

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

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

In contrast, the riskiest and most troublesome activity occurs in those markets that share very few of the features described above. Illiquid securities and complex Over-the-Counter (OTC) derivatives typically trade infrequently and opaquely, outside of organized platforms, and without the convention of fees or commissions. In essence, these products lack all of the necessary qualities to facilitate even the most basic implementation of this Proposed Rule. Regulators will be unable to monitor, verify, or enforce this rule in any meaningful way with respect to these products, and they provide myriad opportunities for large proprietary positions to be justified, disguised, or overlooked.

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

- *Bid/Ask Spreads*

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

> Generally, the revenues for market making by the covered firms should be made from the fees charged for providing a ready, two-sided market for financial instruments, and not from the changes in prices acquired and sold by the financial institution.[66]

[66] 156 Cong. Rec. S5896 (daily ed. July 15. 2010) (statement of Sen. Merkley).

The designation of bid/ask spreads as appropriate market making revenue is not mentioned, as the generation of such revenue relies exclusively on changes in the market value of the positions or risks held in inventory. "Revenues **primarily** from fees, commissions, bid/ask spreads or other similar income"[67] is functionally identical to "all revenues," to the degree that they can be meaningfully differentiated.[68]

The attempt to reconcile these two conflicting ideas is a primary source of complexity throughout this Proposed Rule, and it serves to meaningfully diminish its effectiveness in practice. The FSOC Study indeed highlighted this issue[69] in its recommendations, and yet it remains as a cornerstone of the Rule's structure.

There are few reasonable solutions to the regulatory problems posed by bid/offer spreads within illiquid markets. Our primary recommendation would be to honor the statute by removing illiquid and OTC products from the market making exemption. An alternative remedy would be to require the disgorgement of all profits from market making related activities.[70] This would eliminate the problem of differentiation of revenues, in addition to significantly reducing the incentive to take prohibited proprietary exposures. For further discussion, please see our answer to Question 82, where we provided a basic example to illustrate some of the failings of the implementation of the revenue requirement.

- *Hedging*

The complicated risk profiles of derivative products require a variety of piecemeal trades to hedge each component risk, and each of these hedges presents new exposures that also require hedging. The trading books of such products quickly become a complicated web of inter-dependent trades that are increasingly difficult to adequately unwind. Illiquid products, for which good hedges rarely exist,[71] are mitigated through proxy hedges[72] that are imperfect

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[67] NPR at 68,872 (discussion of the fifth market making criterion, § _.4(b)(2)(v)) (emphasis added).
[68] The inclusion of the word "primarily" serves to further erode this requirement.
[69] FSOC Study, *supra* note 54, at 24 ("[M]easuring the revenue that is attributable to the bid-ask spread is difficult and not consistently observable especially in illiquid markets.").
[70] We emphasize that customer-services are rarely profit centers, and the necessity of profiting from the customer-service of market making should not be taken for granted.
[71] *See* AllianceBernstein's Comment Letter re Prohibitions and Restrictions on Proprietary Trading – File S7-41-11 6 (Nov. 16, 2011), *available at* http://www.federalreserve.gov/SECRS/2011/November/20111129/R-1432/R-1432_111611_88542_412445985793_1.pdf ("Certainly there are segments of fixed income markets and OTC markets where such hedges do not exist or markets where even the best structured hedges fail to protect the hedging party fully. It is impossible to predict what the behavior of even the most highly correlated hedge will be versus the underlying asset being hedged.").
[72] Interview by Financial Crisis Inquiry Commission with David Bushnell, Former Chief Risk Officer for Citigroup 45 (Apr. 1, 2010), *available at* http://ebookbrowse.com/2010-04-01-transcript-of-fcic-staff-interview-with-david-bushnell-citigroup-pdf-d250783037 ("[I]n this secondary trading desk they would take positions in different tranches of CDOs, triple B, single A, double A positions, to facilitate customer liquidity and customer inquiries. If

(indeed sometimes completely unrelated), but available and economical.[73] In other cases, such risks are seen as uneconomical to hedge at all.[74] This issue is addressed in greater detail below.

- *Warehousing Illiquid Risk*

In explanation of the statutory prohibition of high-risk assets and strategies[75], Senator Merkley stated:

> With respect to the definition of high-risk assets and high-risk trading strategies, regulators should pay close attention to the characteristics of assets and trading strategies that have contributed to substantial financial loss, bank failures, bankruptcies, or the collapse of financial firms or financial markets in the past, including but not limited to the crisis of 2008 and the financial crisis of 1998. In assessing high-risk assets and high-risk trading strategies, particular attention should be paid to the transparency of the markets, the availability of consistent pricing information, the depth of the markets, and the risk characteristics of the assets and strategies themselves.[76]

There were few greater contributors to the most recent financial crisis than the warehousing of large illiquid positions. The accumulation of assets for which there is no willing buyer or price clarity is a very risky practice. When this happens throughout an industry that relies heavily on very short-term (often overnight) funding, this practice can prove to be systemically disastrous. It is inconsistent with Congressional intent for the Rule to create allowances for businesses that require significant risk-taking as a matter of course; unfortunately, that is the very nature of market making in illiquid products. This issue is a major concern of the FSOC Study, which states that inventory management related to market making "is especially complex in illiquid markets, as a market maker may be required to assume significant market risk between the time that the large order is purchased and sold back into the market."[77]

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they happened to be holding a position and they wish to hedge its price volatility, they would use another instrument, ABX indices which traded. in an attempt to hedge the price volatility of the position that they had.").

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

[74] FSOC Study, *supra* note 54, at 20 ("In general. it may be uneconomical to completely hedge all of the risk to which a trading desk is exposed.").

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

[76] 156 Cong. Rec. S5897 (daily ed. July 15. 2010) (statement of Sen. Merkley).

[77] FSOC Study, *supra* note 54, at 19.

We are unable to reconcile the allowance for market making in illiquid assets with either the intentions of Congress, the guidance of the FSOC Study, or the true intention of the Agencies to prohibit potentially harmful activities within covered banking entities.

- *Provision of Meaningful Data*

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

Former SEC Chairman Harvey Pill recently stated:

> First, there has to be a universal requirement that anyone that takes money from the public that can have an impact on the economy must provide a continuous flow of significant data.[78]

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

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

- *Near-term Demands*

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

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

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

Question 86. Are there other market making-related activities that the rule text should more clearly permit? Why or why not?

The extensive permissions render the proprietary trading prohibition, with respect to market making, entirely ineffective. It would be entirely negligent of Congressional intent to suggest that further permissions may be appropriate.

Question 87. Are the seven criteria included in the market-making exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other criteria be added?

As discussed in Question 85, the seven criteria are applicable to only a small group of highly liquid assets. To all illiquid and OTC products, most of the proposed criteria are completely ineffective. We discuss each of the criteria in detail below.

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

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

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

A straightforward way to improve the efficacy of compliance regimes is to enact a re-focusing of compensation incentives within compliance organizations of covered banking entities. A two tiered approach could 1) bring the general level of compensation of compliance professionals to be more in line with those in the front office, to more accurately demonstrate the importance of these roles to the quality of the banking entity itself, and 2) require a compensation design which explicitly rewards quality practices and their implementation.[79] Similarly, banking entities would be served by applying the same structural changes to other important operational groups such as Product Control, Operational Risk Management, and Information Technology.

2) Bona Fide Market Making
As we discussed in Question 85, the clear attribution of market making is difficult in all illiquid and OTC markets. We propose an alternative definition of market maker in Question 88.

3) Reasonably Expected Near-term Demands of Clients, Customers, and Counterparties
Liquid, exchange-traded products often make use of metrics of market transparency to provide market makers with useful information about market depth, which in turn allows them to form reasonable expectations about their customers' near-term demands.[80] All other markets (namely OTC and illiquid) lack the fundamental structure that allows for such insights. In practice, such near-term demand is most often estimated by vague intuitions like: "The market is going up, so my clients will probably want to be buyers,"[81] more troublingly, "I want to buy here, so my clients will likely want to buy as well," or unlawfully, "I have non-public information that indicates that my clients will be buyers." This concern was raised in the Supplementary Information for this Proposed Rule,[82] but the Rule fails address this concern by requiring that the other sources of such information be demonstrable and verifiable by regulators.

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[79] Programs such as the SEC's Whistleblower program are a relevant incentivization program that may be used as a reference for such reforms. Sec. & Exch. Comm'n, *Dodd-Frank Act Rulemarking: Whistleblower Program*, http://www.sec.gov/spotlight/dodd-frank/whistleblower.shtml (last visited February 4, 2012).
[80] For instance, such information can include Level 2 market data or NASDAQ's Depth of Book data.
[81] *See* Mark Pengelly, *Finding Volcker Rule Metrics will be Tough, Dealers Warn*, Risk.net, Aug. 1, 2011, http://www.risk.net/risk-magazine/feature/2096530/finding-volcker-rule-metrics-tough-dealers-warn ("We're not a pure agency business or a proprietary trading operation – we're a principal trading business. If a trader comes in first thing in the morning and sees that S&P 500 volatility is trading cheap, we'll buy $10 million of it. Trading in advance to facilitate client activity is part of what we do.").
[82] NPR at 68,871 (discussion of the third market making criterion, § _.4(b)(2)(iii)) ("In order for a banking entity's expectations regarding near-term customer demand to be considered reasonable, such expectations should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects.").

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

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

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

> Frontrunner[s] use their access to material nonpublic market information to take unfair advantage of other market participants.[83]

The proposed rule makes it very clear that a banking entity may *not* accumulate inventory in advance of customer trades, unless such accumulation is based on specific information about the near-term demands of their client base. Presumably, such specific future flow information would be considered "nonpublic." Further, banking entities may *not* base such anticipatory accumulation on what would be public information, such as general market expectations of price appreciation. We see in the NPR's discussion of § _.4(b)(2)(iii):

> In order for a banking entity's expectations regarding near-term customer demand to be considered reasonable, such expectations should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects. Rather, a banking entity's expectation should generally be based on the unique customer base of the banking entity's specific market-making business lines and the near-term demands of those customers *based on particular factors beyond a general expectation of price appreciation.*[84]

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[83] U.S. General Accounting Office. *Securities and Futures Markets: Efforts to Detect Intermarket Frontrunning*, GAO/B-245321 (Washington, D.C.: Sep. 26, 1991), *available at* http://archive.gao.gov/d18t9/145088.pdf.
[84] NPR at 68,871 (emphasis added).

It is difficult to imagine a situation then, where a banking entity would be accumulating demand based on legitimate public information that is "related to clear, demonstrable trading interest of clients, customers, or counterparties"[85] as such information is indeed rarely made public.

We see the clear potential for conflict and confusion with respect to this rule, and suspect that market makers may begin engaging in increasingly conflicted activities under the protection of this Rule. We see the demand anticipation criterion as not only unnecessary to the description of bona fide market making, but also a potential source of great divergence in the interests of market makers and their clients. This potentially harmful conflict of interest was highlighted in the FSOC study,[86] and we urge the Agencies to reconsider the appropriateness of this requirement in light of the coinciding statutory prohibition of such a conflict.[87] Anticipatory accumulation of inventory should be removed from the description of market making, and considered to be prohibited proprietary behavior.

We recognize that this Proposed Rule draws directly from the language of the statute. However, this potentially harmful conflict of interest was highlighted in the FSOC Study,[88] and we urge the Agencies to reconsider the appropriateness of this requirement in light of the coinciding statutory prohibition of such a conflict.[89]

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

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

[86] FSOC Study, *supra* note 54, at 48 ("Proprietary trading presents potentially serious conflicts of interest between a firm's activities that take a directional view and the customer-serving activities that should facilitate proper functioning of markets. A customer could unknowingly suffer financial injury if, for example, the firm were to trade ahead of customer orders or anticipated orders for financial instruments and profit from changes in the market price resulting from the customer's order. Or the firm could trade based on information about a future underwriting deal for the customer, or knowledge of a customer's portfolio of securities.").

[87] 12 U.S.C. § 1851(d)(2)(A)(i).

[88] FSOC Study, *supra* note 54, at 48 ("Proprietary trading presents potentially serious conflicts of interest between a firm's activities that take a directional view and the customer-serving activities that should facilitate proper functioning of markets. A customer could unknowingly suffer financial injury if, for example, the firm were to trade ahead of customer orders or anticipated orders for financial instruments and profit from changes in the market price resulting from the customer's order. Or the firm could trade based on information about a future underwriting deal for the customer, or knowledge of a customer's portfolio of securities.").

[89] 12 U.S.C. § 1851(d)(2)(A)(i).

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

4) Revenues from Fees, Commissions, Bid/ask Spreads or Other Similar Income
This is perhaps the most complicated, and least indicative, criterion in the list. First, it should be emphasized that revenues from commissions and fees are extremely dissimilar from revenues from bid/ask spreads, to the extent that the latter can be seen as compensation. The allowance for bid/offer revenues in market making is one of the largest opportunities for abuse in the entire proprietary trading regulations. Regulators will be unable to monitor, verify, or enforce this rule in any meaningful way, and it is an enormous loophole through which much of the riskiest proprietary trading can and will occur. For an extensive discussion of this issue, please see part *a* of Question 85.

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

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

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

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

The Supplementary Information and Appendix B Commentary serve to significantly water down the sentiment of the compensation requirement. For example, the Supplementary Information weakens the Rule [90] by adding the word "primarily"[91], and should be substantially re-written. The Commentary in Appendix B explains that some consideration of profitable hedging activities should be acceptable, which implicitly provides for inappropriate incentives.

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

In consideration of technical issues, there is an inconsistency between the rule text and the Supplementary Information with respect to explanatory facts and circumstances. A footnote[92] in the Supplementary Information states the obvious fact that such facts and circumstances could not reasonably exist to explain compensation incentives that are inconsistent with the Proposed Rule. Acknowledgement of this fact should be made explicit in the rule text itself, which currently allows for explanatory facts and circumstances regarding all of the market making criteria, including compensation incentives. We have proposed significant improvements to the

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

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

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

language of the Commentary in Appendix B, which we have submitted as an appendix to this letter.

6) Consistency with Appendix B Commentary
It is clear that much of this Proposed Rule has been based on the model of highly liquid exchange-traded equity markets. Although this is a great simplifying factor, it is a tremendously unrealistic one. The Commentary in Appendix B is an example of how this rule tends to account for only the most liquid and transparent markets (i.e., listed equities, U.S. Treasuries), and fails to accurately describe market making in most illiquid or OTC markets. We find this particularly troubling, given that this benchmark asset type was not considered to be a contributor to the most recent crisis, and is not expected to present significant opportunities to evade this rule. Illiquid markets were and continue to be havens of risky and irresponsible activity, yet they are largely forgiven throughout this rule. We will discuss these issues further in the Questions specifically referencing the Appendix B Commentary, and we have attached as an appendix an alternative Commentary that better reflects our concerns.

Question 88. Is incorporation of concepts from the definition of "market maker" under the Exchange Act useful for purposes of section 13 of the BHC Act and consistent with its purposes? If not, what alternative definition would be more useful or more consistent?

As we have mentioned in previous answers, it is clear that highly liquid exchange-traded equity markets were the model on which much of this Proposed Rule has been based. Although this is a great simplifying factor, it is a tremendously unrealistic one. Strict adherence of this definition effectively prohibits "market making" in OTC or illiquid markets.

Here we propose an alternative definition of market maker:

> *The term "market maker" means any registered specialist operating on a monitored, multilateral electronic trading facility who is required to hold himself out (by entering contextual and tradable two-sided quotations in a publicly available trading platform) as being willing to buy and sell such security for his own account on a regular and continuous basis.*

Question 89. Is the proposed exemption overly broad or narrow? For example, would it encompass activity that should be considered prohibited proprietary trading under the proposed rule?

The exemption is overly broad as a result of:

- The inclusion of, and many allowances for, Illiquid and OTC products.
  For further discussion, please see Question 85.

- Complete lack of penalties. For further discussion, please see Questions 80 and 81.

Question 90. We seek commenter input on the types of banking entities and forms of activities that would not qualify for the proposed market-making exemption but that commenters consider to otherwise be market making. Please discuss the impact of not permitting such activities under the proposed exemption (e.g., the impact on liquidity).

We can see no activities or entities that would be inappropriately disqualified from using this exemption.

Question 91. Is the requirement that a trading desk or other organizational unit relying on the market-making exemption hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the relevant covered financial position for its own account on a regular or continuous basis effective?

This requirement is insufficiently clear. "A regular ***or*** continuous basis" allows a tremendous amount of freedom in interpretation, and lacks any real requirement that can be measured and monitored. It is important to keep in mind that it is possible to make a market outside of the prevailing market context, which would be untradeable in practice (since a higher bid or lower offer is available in the market). It would be possible for a market participant to make wide, out of context markets on a regular or continuous basis, with no real risk of execution. This participant could masquerade as a market maker, maintain access to important market information, trade only when it is advantageous to himself, and provide no liquidity to the market. Further, most markets lack structural frameworks that would provide any reasonable means of confirmation that this requirement is in fact being met.

If not, what alternative would be more effective?

For alternative language defining market maker, please see Question 88.

Does the proposed requirement appropriately differentiate between market making-related activities in different markets and asset classes? If not, how could such differences be better reflected?

For further discussion of this issue, please see Questions 85 and 88.

Should the requirement be modified to include certain arbitrage trading activities engaged in by market makers that promote liquidity or price transparency, but do not serve customer, client or counterparty demands, within the scope of market making-related activity? If so why? How could such liquidity- or price transparency-promoting activities

be meaningfully identified and distinguished from prohibited proprietary trading practices that also may incidentally promote liquidity or price transparency?

Arbitrage scenarios should absolutely ***not*** be included in this proposal. Executing arbitrage trades is one of the purest forms of principal proprietary trading in existence. In the event that an arbitrage scenario exists in such a way that it is inhibiting liquidity or transparency within a market, a market maker could certainly find a customer who would seek to benefit from it, and pass through such gains as a bonus in customer service. There is no reason a market maker should profit from arbitrage opportunities. Further, the practical definition of arbitrage has devolved to the point where extensive explanation would be required by the Agencies to address potential abuse in such a requirement. All activity that does not serve customers should be considered prohibited proprietary activity.

Question 92. Do the proposed indicia of market making in liquid markets accurately reflect the factors that should generally be used to analyze whether a banking entity is engaged in market making-related activities for purposes of section 13 of the BHC Act and the proposed rule? If not, why not? Should any of the proposed factors be eliminated or modified? Should any additional factors be included? Is reliance on the SEC's indicia of bona fide market making for purposes of Regulation SHO under the Exchange Act and the equity securities market appropriate in the context of section 13 of the BHC Act and the proposed rule with respect to liquid markets? If not, why not?

For liquid markets, the indicia are appropriate and consist of the most basic guidelines to be sufficient for the purposes of this Rule. No indicia should be removed from this list. It should be stressed that it should be largely unnecessary for any market maker to warehouse any significant risks for any period of time in liquid markets.

Question 93. Do the proposed indicia of market making in illiquid markets accurately reflect the factors that should generally be used to analyze whether a banking entity is engaged in market making-related activities for purposes of section 13 of the BHC Act and the proposed rule? If not, why not? Should any of the proposed factors be eliminated or modified? Should any additional factors be included?

As we have discussed at length in Question 85, market making in illiquid markets is extremely inconsistent with the Statute and the intentions of Congress, and should be removed from this rule.

We are very troubled by the inclusion of this "indicia differential" in the Supplementary Information, since it is not included in the text of the Proposed Rule. The Agencies have found that illiquid markets do not meet the requirements of bona fide market making, and so they have weakened the definition in order to include them. Despite the limitations of the above indicia for liquid markets, the definition of good and useful market making should not depend on the nature

of the market being made. If an illiquid market cannot the meet the requirements of this Rule, changes should be made within that market in an attempt to conform, or it should be considered prohibited activity.

We will outline our concerns for each of the illiquid indicia.

• *Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis.*
Regular, but intermittent and unactionable quotes do **not** in fact provide liquidity. This is a misunderstanding of how provision of liquidity is performed. At its best, indicative market information can provide transparency to a market (assuming the information is legitimately demonstrative of actual tradability). Transparency is an important quality to any market, but should not be confused with liquidity. It is possible to demonstrate true willingness and availability to provide liquidity by providing tradable markets in a publicly available and multilateral electronic trading facility.

• *With respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market.*
The removal of the requirement that such buying and selling must be in roughly similar size allows for significant accumulation of illiquid risk in the course of market making. This is an irresponsible indicia and should be amended to match the corresponding liquid indication.

• *Transaction volumes and risk proportionate to historical customer liquidity and investments needs.*
Unfortunately, most illiquid markets have no source for such historical risk and volume data. This is not a meaningful requirement without a centralized, market-wide repository of data upon which such a requirement could be based. Further, the historical liquidity and investment needs will be undifferentiable from the proprietary positioning that occurred before this rule is implemented.

Illiquid markets should be held to the same indicia as liquid markets. These risky assets require more stringent oversight than liquid products, but are given significantly less in this rule.

<u>Question 94</u>. How accurately can a banking entity predict the near-term demands of clients, customers, and counterparties?

For an extensive discussion of this issue, please see Question 87, part 3.

Market makers trading liquid, exchange-traded products, as well as those market makers with an extremely firm grasp of their clients' investment objectives, trading patterns, and general near-term intentions, may have limited information with which to make general predictions of client

demand. These scenarios are *not* ubiquitous, and those circumstances that meet this criterion without constituting illegal front running are *dangerously few*. This is a nonsensical requirement with extremely dubious applications and the Agencies should seriously reconsider its place in this or any rule.

Are there measures that can distinguish the amount of principal risk that should be retained to support such near-term client, customer, or counterparty demand from positions taken for speculative purposes?

There are absolutely not any measures that indicate such an amount. Principal risk retention is *not* a requirement of true market making.

How is client, customer, or counterparty demand anticipated in connection with market making-related activities, and how does such approach vary by asset class?

See above.

Question 95. Is the requirement that a banking entity relying on the market-making exemption be registered as a dealer (or in the case of a financial institution that is a government securities dealer, has filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act), or exempt from registration or excluded from regulation as a dealer under relevant securities or commodities laws effective? If not, how should the requirement be changed? Does the requirement appropriately take into account the particular registration requirements applicable to dealing in different types of financial instruments? If not, how could it better do so? Does the requirement appropriately take into account the various registration exemptions and exclusions available to certain entities, such as banks, under the securities and commodities laws? If not, how could it better do so?

In a regulatory regime that imposes a specific definition of who is to be considered a market maker, it makes sense that entities that intend to provide such services be required to register as such. An industry-wide dealer registration process, in combination with a professional certification for individual market makers, would be simple and appropriate requirements.

Question 96. Is the requirement that a trading desk or other organizational unit of a banking entity relying on the market-making exemption be designed to generate revenues primarily from fees, commissions, bid/ask spreads or similar income effective? If not, how should the requirement be changed? Does the requirement appropriately capture the type and nature of revenues typically generated by market making-related activities? Is any further clarification or additional guidance necessary? Can revenues primarily from fees, commissions, bid/ask spreads or similar income be meaningfully separated from other types of revenues?

This requirement is ineffective. There is no practicable way to differentiate customer-driven trading revenues from proprietary gains when such customer revenues are in the form of bid/ask spreads.

Bid/ask spreads are unfortunately unavoidable, and should be sized appropriately with the necessary cushion a market maker requires to efficiently mitigate the assumed risks. These bid/asks should not be generating extraneous revenue, or else prohibited proprietary trading is taking place. This is a meaningless requirement in the vast majority of markets in which it will be employed.

For further discussion of this issue, please see Question 87, part 5.

Question 97. Is the requirement that the compensation arrangements of persons performing market making-related activities at a banking entity not be designed to encourage proprietary risk-taking effective? If not, how should the requirement be changed?

For an in-depth discussion of this issue, please see Question 87, part 6. We propose the following change to the language of § _.4(b)(2)(vii) of the Proposed Rule:

> The compensation arrangements of persons performing the market making-related activities ~~are designed not to~~ *do not* reward proprietary risk-taking.

Furthermore, in order to be consistent with the intentions of the statute, the explanation of this sixth criterion in the Supplementary Information should be changed to the following:

> Under § _.4(b)(2)(vii) of the Proposed Rule, the compensation arrangements of persons performing market making-related activities at the banking entity must ~~be designed~~ not ~~to~~ encourage or reward proprietary risk-taking. Activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position held in inventory, rather than success in providing effective and timely intermediation and liquidity services to customers, are inconsistent with permitted market making-related activities. ~~Although a banking entity relying on the market-making exemption may appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed principal risk retained, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not proprietary risk-taking~~.

Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted market making-related activity?

All compensation incentives must be, at the very least, based on a metric that meaningfully and responsibly accounts for the risk assumed in the process of making markets, as well as the quality of customer service conducted.

Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?

Rewarding trading profits of any kind, or any reference to budgets or profit targets, would be specific identifiable characteristics of prohibited incentives.

Question 98. Is the inclusion of market making-related hedging transactions within the market-making exemption effective and appropriate?

We see the potential for an enormous amount of confusion due to this inclusion. We believe it would be much more straightforward for client-facing market making trades to be included in the Market Making exemption, and other hedge-related trades to be appropriately included in the Risk-Mitigating Hedging exemption. This will assist the Agencies in clearly distinguishing between explicit client-related activity, and other potentially evasive hedging activity. Our specific concerns with respect to the hedging exemption will be addressed in the questions for that section.

Are the proposed requirements that certain hedging transactions must meet in order to be considered to have been made in connection with market making-related activity effective and sufficiently clear? If not, what alternative requirements would be more effective and/or clearer? Should any of the proposed requirements be eliminated? If so, which ones, and why?

We find it unclear as to the specific advantage to claiming a specific hedging activity fell under the market-making exemption as opposed to the general risk-mitigating hedging exemption.

Question 99. Should the terms "client," "customer," or "counterparty" be defined for purposes of the market-making exemption? If so, how should these terms be defined? For example, would an appropriate definition of "customer" be: (i) a continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction; (ii) a direct and substantive relationship between the banking entity and a prospective customer prior to the transaction; (iii) a relationship initiated by the banking entity to a prospective customer to induce transactions; or (iv) a relationship initiated by the prospective customer with a view to engaging in transactions?

The need to identify and quantify which trades are in fact customer servicing and "customer-initiated"[93] is central to the implementation of this Rule. This can only be sensibly accomplished with a clear and specific definition of customer.

The Proposed Rule tends to group *customer* with the terms *client* and *counterparty*, and would implicitly or explicitly treat trades between banking entities as legitimate market making activity. In theory, a banking entity could establish a market making business that consists exclusively of trades "with the street" through inter-dealer brokers. Clearly, this scenario does not fit the description of the "customer service" that Congress sought to protect and exempt. Intermediating between two banking entities that neither request nor require such intermediation provides no added liquidity or efficiency to a market. We concede that such street trading may serve a liquidity function by availing the capacity to hedge the risks borne of legitimate client trades, but if a trade with another covered banking entity is conducted for the purposes of risk-mitigating hedging, it should be demonstrable as such and consistent with the guidelines for the Risk-Mitigating Hedging exemption.

The presumption underlying the market making exemption is that banking entities provide a variety of financial services to their client base, and market making is an essential facet of a holistic business. In this case, it should be easy to demonstrate an existing pattern of mutually beneficial business activities, outside of market making, with any customer for the purposes of this definition. Additionally, it is clear that the services provided by a banking entity are sufficiently well-known that an appropriate customer base is willing and able to initiate a relationship with a banking entity in the absence of direct or indirect solicitation. The Agencies should require that relationships are pre-existing and customer-initiated in order to qualify as customers with respect to this exemption.

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

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

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[93] FSOC Study, *supra* note 54, at 3.

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

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

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

Question 100. Are there other types of market making-related activities that should also be included within the scope of the market-making exemption? If so, what additional activities and why? How would an exemption for such additional activities be consistent with the language and intent of section 13 of the BHC Act? What criteria, requirements, or restrictions would be appropriate to include with respect to such additional activities? How would such criteria, requirements, or restrictions prevent circumvention or evasion of the prohibition on proprietary trading?

No. The current exemption for market making is far too broad as it stands. It would be irresponsible to extend the exemption in any way from its current form.

Question 101. Do banking entities currently have processes in place that would prevent or reduce the likelihood of taking speculative, proprietary positions in the context of, or mischaracterized as, market making-related activities? If so, what processes?

Since a model of maximizing profitability has been the standard, it would be unreasonable to assume that processes to limit such activity would ever exist in the absence of regulation.

Question 102. Is the proposed rule's approach to implementing the hedging exemption effective? If not, what alternative approach would be more effective?

The hedging exemption is ineffective as it applies to derivatives and other structured products. The complicated risk profile of such products calls for a variety of piecemeal hedge trades for each component risk, all of which can present new exposures that then need to be hedged by more piecemeal trades. The resulting trading book quickly becomes a complicated web of trades that are increasingly difficult to adequately unwind.

Question 103. Does the proposed multi-faceted approach appropriately take into account and address the challenges associated with differentiating prohibited proprietary trading

from permitted hedging activities? Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

The proposed multi-faceted approach takes into account some, but not all of the challenges associated with differentiating prohibited from permitted activity. Specific additional considerations are outlined in the following questions, but in general we see this particular exemption as far too complicated to enact with any degree of effectiveness. Illiquid products often have no appropriate hedges, and are irresponsibly managed through a series of imperfect trades that each present new exposures in need of mitigation. Derivatives require a similar process of piecemeal "hedge" construction. Within even the most basic portfolio will exist ample opportunity to disguise proprietary activity, and we are discouraged by the dearth of meaningful improvements that can be made to this rule. Prohibiting market making in illiquid securities and OTC derivatives would be an obvious improvement, but as long as they remain permitted we see the risk-mitigating hedging exemption as a failure.

Question 104. Does the proposed approach to implementing the hedging exemption provide banking entities and market participants with sufficient clarity regarding what constitutes permitted hedging activities? If not, how could greater clarity be provided?

The extent to which a given trade can be designated as an appropriate hedge of any other trade becomes less clear as the product in question becomes less liquid. To provide greater clarity, the Agencies could:

- Prohibit market making in assets with complicated risk profiles (e.g., OTC derivatives, Fixed Income, other illiquid positions, etc.).

- Explicitly limit the universe of acceptable hedges to those that are universally understood as appropriate for a given product.

Question 105. What impact will the proposed approach to implementing the hedging exemption have on the hedging and risk management activities of a banking entity and the services it provide to its clients? If any of these impacts are positive, how can they be amplified? If any of these impacts are negative, how can they be mitigated?

The impact of this approach on banking entities and their client service will be minimal. However, it is easy to imagine that the complicated web of partial hedges, as allowed by the Rule, will be extremely difficult to effectively monitor and regulate. Much of this resulting burden, of course, will be borne by the Agencies as they attempt to identify evasion in this process. This negative impact can be somewhat mitigated in the following ways:

- Impose strict limits on what constitutes an appropriate hedge, with anything less than full or complete hedging discouraged or prohibited. This will significantly simplify the resulting risk profile of every hedged trade.
- Require that each type of exposure (Counterparty, Market, Inflation, Interest Rate, etc.) be designated exclusively as hedged individually, or in aggregate. Requiring risk factors to be hedged at multiple levels is irresponsible and complicating.
- Develop and maintain a database of appropriate and qualifying hedging products for each asset.

Question 106. What burden will the proposed approach to implementing the hedging exemption have on banking entities? How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?

We encourage the Agencies to require much more robust reporting requirements for all trades seeking to rely on this exemption. For further discussion of this issue, please see Question 114.

Question 107. Are the criteria included in the hedging exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other requirements be added?

The criteria in this exemption are necessary, but insufficient to be truly effective. Discussions and suggestions for the improvement of each criteria will be included in the following questions.

Question 108. Is the requirement that a transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity effective?

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

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

> [h]edge[] or otherwise mitigate[] one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity;

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

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

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

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

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

If not, what requirement would be more effective?

We suggest the explicit removal of "basis risk, or similar risks" from this criteria. Additionally, a specific requirement that each type of exposure be designated as one that is hedged exclusively on an individual or an aggregate basis is essential.

Does the proposed approach sufficiently articulate the types of risks that a banking entity typically hedges?

There are many other risks that are not accurately addressed in this exemption as they are difficult to hedge in practice without exposure to other risks. Notable among these are:

Default Risk: Hedging default risk typically involves buying/selling short-term protection on a rolling basis as longer-dated contracts expire. Significant short-term credit risks must be assumed in order to hedge this rolling default risk. Default risk also serves to highlight the practical impossibility of effective hedging of derivatives transactions. This is one of many reasons we encourage the Agencies to prohibit all derivatives and illiquid market-making activities.

Liquidity Risk: This is the most glaring absence from the risk considerations in this Proposed Rule. Adequately preparing for the often significant changes in risk profile that occur in illiquid markets is the single most important preventative measure a bank can take to ensure that disruptive events do not turn into systemic collapses. The failure to do so was a primary cause of the recent financial crises,[94] and this should be a primary focus of all risk management procedures in a post-crisis world. The most effective way to hedge against liquidity risk is to limit inventories such that they are proportional to the relative illiquidity of the product.

Does the proposal sufficiently address application of the hedging exemption to portfolio hedging strategies? If not, how should the proposal be changed?

No. A specific requirement that each type of exposure be designated as one that is hedged exclusively on an individual or an aggregate basis is essential. Risks should never be hedged on both an individual and aggregate basis, and most risk types are appropriately mitigated in only one of the categories. For instance, counterparty risk should always be (and in practice, typically always is) mitigated on a portfolio basis, and individual traders should not be able to make use of the hedging exemption by claiming mitigation of such a risk. For additional discussion of this issue, please see Question 109.

<u>Question 109</u>. Does the manner in which section __.5 of the proposal would implement the risk-mitigating hedging exemption effectively address transactions that hedge or otherwise mitigate specific risks arising in connection with and related to <u>aggregated</u> positions, contracts, or other holdings of a banking entity? Do certain hedging strategies or techniques that involve hedging the risks of aggregated positions (e.g., portfolio hedging) (i) create the potential for abuse of the hedging exemption or (ii) give rise to challenges in determining whether a banking entity is engaged in exempt, risk-mitigating hedging activity or prohibited proprietary trading? If so, what hedging strategies and techniques, and how? Should additional restrictions, conditions, or requirements be placed on the use

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[94] *See* Garry J. Schinasi, *Safeguarding Financial Stability: Theory and Practice* 214 (International Monetary Fund 2005) ("Market participants acknowledge their previous failures to realize the importance of liquidity risk in OTC derivatives, and that the capacity to manage it is still in an embryonic stage. One common mistake in 1998 was that risk management systems assumed markets would remain liquid and price changes would follow historical norms. Risk managers also failed to engage in stress testing to examine the implications of severe liquidity problems. Few firms were, for the purposes of risk management, marking credit exposures to estimated liquidation values instead of to current market values.").

of the hedging exemption with respect to aggregated positions so as to limit potential abuse of the exemption, assist banking entities and the Agencies in determining compliance with the exemption, or otherwise improve the effectiveness of the rule? If so, what additional restrictions, conditions, or requirements, and why?

We are alarmed by the focus on "portfolio hedging" throughout the Risk-mitigating hedging exemption. We interpret the intent of this exemption as relating to Delta One or central execution desks that have become ubiquitous across banking entities in recent years. Certainly these central hedging operations pose significant risks, as famously exemplified in the rogue trading scandal that caused a $2.3 billion loss in 2011.[95] While it is clear that such practices necessitate increased oversight and significantly improved risk-management procedures, there are other instances of aggregated hedging that will be inappropriately included within "portfolio hedging" that require consideration. Even outside of central execution desks, many risks are currently managed on an aggregated basis, due to the numerous, and often compounding, proprietary portfolios that exist on every market making desk of every covered banking entity. With so many independent strategies at play, it is not uncommon for large exposures across a variety of assets to result when they are combined in the view of a manager. Management will often make use of a "back book" or "management book" for the dual purposes of conducting broad-line hedges against lumpy trading-desk exposures, ***and*** taking proprietary positions that fall outside of the mandate or risk limits of an individual trader. While it is expected that such obvious proprietary exposures will diminish with the implementation of this Rule, we fail to understand the continued relevance of most management hedging operations once individual trading books pare their component exposures. **We are troubled by the potential for such "back books" to become havens of prohibited proprietary activity after the implementation of this Rule.**

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

The broad allowance for aggregated hedging is troubling and its exemption is inconsistent with the intentions of this Rule. This rule mandates strict risk mitigation at a micro level, and should remove all implicit or explicit allowances for the dangerous practice of management hedging.

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

More generally, a banking entity's need for substantive aggregated hedging is indicative of a failure to appropriately mitigate risks at lower levels within an entity, and is therefore in violation of the spirit of the Rule. We acknowledge that the statute allows for aggregated hedging in Section 619(d)(1)(C)[96], and we hope that the Agencies are prepared to be diligent in monitoring this activity closely to discourage abuses, which we see as a serious risk.

Question 110. Is the requirement that the transaction be reasonably correlated to the risk or risks the transaction is intended to hedge or otherwise mitigate effective?

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

> A transaction that is only tangentially related to the risks that it purportedly mitigates would appear to be indicative of prohibited proprietary trading.[97]

We understand this to mean that the Agencies define "reasonable" as somewhere between tangentially related and perfectly offsetting. This is an unworkably broad definition. It is, of course, not uncommon for correlation to exist among a variety of semi-related financial instruments. Increasingly, banks are developing sophisticated hedging algorithms to determine the cheapest hedge that satisfies correlation inputs, leading to decreased reliance on common-sense oversight.[98] The degree of correlation, horizon over which the correlation exists, and circumstances causing the correlation to exist are important considerations that are undermined by the inclusion of the word "reasonably."

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[96] 12 U.S.C. § 1851(d)(1)(C). *See also* Proposed Rule § _.5(b)(2)(ii) ("Hedges or otherwise mitigates one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity").

[97] NPR at 68,875 (discussion of § _.5(b)(2)(iii)).

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

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

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

If not, how should the requirement be changed?

The basis of "reasonable correlation" to determine an appropriate hedge should be removed. Those assets that are appropriate hedges for any given transaction are known and agreed upon throughout its market. It would serve the Agencies to maintain a database of qualifying hedges by product in order to assist the monitoring process. Banking entities should not be allowed to retroactively claim that an abnormal or unusual asset happened to meet this rule's overly-vague criteria and so qualifies as a permitted hedge.

Should some specific level of correlation and/or hedge effectiveness be required? Should the proposal specify in greater detail how correlation should be measured?

It would be disingenuous to presume that traders are unable to identify those products that would or would not behave as appropriate, correlated hedges for their own books. As mentioned above, there should exist a central database that catalogues the hedges that are consistently appropriate for each product. The Agencies should be prepared to prohibitively penalize violations.

Should the proposal require hedges to be effective in periods of financial stress?

Yes. This is one of several improvements that would lead to higher quality hedges, and simpler resulting risk profiles. Hedges that are truly appropriate will indeed satisfy this requirement. In the absence of such a requirement, the current hedging requirement will lead to extremely complicated risk profiles (as banking entities begin relying on the cheapest satisfactory hedge,

and go on to further imperfectly hedge their hedges, etc.). This kind of forward-looking requirement encourages responsibility and complicates attempted evasion.

Does the proposal sufficiently reflect differences in levels of correlation among asset classes? If not, how could it better do so?

As stated above, the understanding of a truly appropriate hedge for a given product is generally consistent industry wide, and attempts to rely on this exemption by unorthodox strategies should be considered suspicious. It should be the responsibility of the trader to demonstrate to the Agencies that a specific level of correlation is indeed appropriate.

Question 111. Is the requirement that the transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction effective?

This requirement is necessary but insufficient to beget meaningfully responsible hedging activity. This requirement should extend throughout the life of the hedge, not merely at the inception.

Does the requirement establish an appropriate range for legitimate hedging while constraining impermissible proprietary trading?

No. This requirement establishes an irresponsibly broad range for legitimate hedging that provides for extensive impermissible proprietary trading.

Is this requirement sufficiently clear? If not, what alternative would be more effective and/or clearer?

As discussed in more detail in Question 110, we suggest a central database of appropriate hedges per product.

Are there types of risk-mitigating hedging activities that may give rise to new and significant exposures that should be permitted under the hedging exemption? If so, what activities?

No. Such activities do not, and cannot, exist. This question seems to suggest that there are some risks that are seen to be by the Agencies as "good" or "harmless." This is a very dangerous concept to introduce in a regulatory context, and we foresee many dangerous implications from the industry viewing certain kinds of exposures as benevolent or inconsequential to regulators.

Should the requirement that no significant exposure be introduced be extended for the duration of the hedging position? If so, why?

Absolutely. Without this requirement, the hedging exemption would be nonsensical. The continuous dynamic management of risks in all markets, with particular importance in all derivatives markets, is absolutely the most important factor in responsible risk management. What is an effective hedge today can easily become a doubling-down tomorrow, and this effect is multiplied as illiquidity and volatility rise. Failing to extend this requirement implicitly allows every kind of proprietary exposure to exist in a portfolio, under the guise of the risk-mitigating hedging exemption.

Imagine a situation where a regulator finds a large troublesome exposure in the book of a market maker, who explains that the exposure arose from a legitimate hedge to a trade he did a few years ago. This situation could (and likely will) occur in every product across every banking entity.

This extension would significantly improve the current language in § _.5(b)(2)(v)(iii), which requires the continual review, monitoring, and management of a transaction relying on this exemption to "mitigate any significant exposure arising out of the hedge after inception." Prohibiting the use of a "hedge" that could introduce such an exposure would lead to higher quality hedging, and simpler resulting risk profiles.

Question 112. Is the requirement that any transaction conducted in reliance on the hedging exemption be subject to continuing review, monitoring and management after the transaction is established effective? If not, what alternative would be more effective?

This is an incredibly important and crucial element of the hedging exemption. The vast majority of markets, particularly derivatives markets, require constant and robust dynamic risk management. The absolute necessity of this requirement stems from the Rule's failure to require exactly offsetting trades to be considered a hedge. What is an effective hedge today can easily become a doubling-down tomorrow, and this effect is multiplied as illiquidity and volatility rise.

In the absence of this requirement, it would be possible for a trader to take advantage of a momentary correlation between assets to designate a "hedge" today that will in fact be a proprietary position tomorrow.

Question 113. Is the requirement that the compensation arrangements of persons performing risk-mitigating hedging activities at a banking entity be designed not to reward proprietary risk-taking effective? Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted risk-mitigating hedging activity? Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?

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

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

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

For further discussion of this issue, please see Question 97.

If not, how should the requirement be changed?

In the absence of a very specific set of guidelines imposed on banking entities as we describe above, we propose the following changes to the current language of the NPR:

> Seventh, § _.5(b)(2)(vi) of the Proposed Rule requires that the compensation arrangements of persons performing the risk-mitigating hedging activities ~~are designed~~ *do* not ~~to~~ reward proprietary risk-taking. Hedging activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position, rather than success in reducing risk, are inconsistent with permitted risk-mitigating hedging activities.

<u>Question 114</u>. Is the proposed documentation requirement effective? If not, what alternative would be more effective?

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

> § _.5(c) Documentation. With respect to any purchase, sale, or series of purchases or sales conducted by a covered banking entity pursuant to this § _.5 for risk-mitigating hedging purposes ~~that is established at a level of organization that is different than the level of organization establishing or responsible for the positions, contracts, or other holdings the risks of which the purchase, sale, or series of purchases or sales are designed to reduce~~, the covered banking entity must, at a minimum, document, *with particularity,* at the time the purchase, sale, or series of purchases or sales are conducted risk-mitigating purpose of the transaction and identify the risks of the individual or aggregated positions, contracts, or other holdings of a banking entity that the transaction is designed to reduce.

Are there certain additional types of hedging transactions that should be subject to the documentation requirement? If so, what transactions and why? Should all types of hedging transactions be subject to the documentation requirement? If so, why?

All hedging should be subject to the documentation requirement, because any "hedge" can potentially be a prohibited proprietary trade, and the Agencies must be able to clearly identify which trades were conducted for which purposes. The onus must be on the banking entities to prove that their activities are within the bounds of the permitted activities in this Proposed Rule. Those trades for which a banking entity is unable to do so must be considered prohibited proprietary activity.

Should banking entities be required to document more aspects of a particular transactions (e.g., all of the criteria applicable to § _.5(b) of the proposed rule)? If so, what aspects and why? What burden would the proposed documentation requirement place on banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?

As a group that includes former traders, we feel that it is important to emphasize that traders are typically intimately aware of their risk profiles at all times, and the impact of trades they conduct. If a trader does not have time to jot down a few known details of a given trade, the Agencies can be assured that he has not adequately thought through the impacts of the trade, which consequently cannot be considered a legitimate risk-mitigating hedge.

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

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

<u>Question 115</u>. Aside from the required documentation, do the substantive requirements of the proposed risk-mitigating hedging exemption suggest that additional documentation would be required to achieve compliance with the proposed rule? If so, what burden would this additional documentation requirement place on banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?

As discussed in Question 114 above, extensive additional documentation requirements are necessary to achieve compliance with the Proposed Rule. The "burden" of quickly committing known information to paper or database is both negligible and essential for the proper implementation of the Rule.

It is our hope that the Proposed Rule will encourage banking entities to pay greater attention to risk profiles, and promote a more holistic and responsible approach to risk management throughout the industry. We see this increased diligence as a benefit, not a burden, regardless of the amount of paperwork it may necessitate.

Question 116. Is the proposed rule's approach of identifying which of the statutory exemptions contained in section 13(d)(1) of the BHC Act apply to the proposed rule's proprietary trading provisions effective and/or consistent the language and purpose of the statute? If not, what alternative would be more effective and/or consistent with the language and purpose of the statute?

The four "other permitted trading activities" appear to be those that apply to proprietary trading, consistent with the statute.

It is worth reiterating that the exemption of repurchase and reverse repurchase agreements is inappropriate and in conflict with the intentions of the statute. We discuss this issue at greater length in Question 30.

Question 117. Are there statutory exemptions that should apply to the proposed rule's proprietary trading provisions that were not included? If so, what exemptions and why?

No. Everything in the statute is accounted for.

Question 118. Are there statutory exemptions that were included in the proposed rule's proprietary trading provisions that should not have been included? If so, what exemptions and why?

We recognize that the Agencies have incorporated all possible statutory exemptions into the Proposed Rule.

Question 119. Is the proposed rule's application to trading in government obligations sufficiently clear? Should such obligations expressly include, for example, instruments issued by third parties but insured or guaranteed by an enumerated government entity or otherwise backed by its full faith and credit?

The Proposed Rule's application to trading in government obligations is consistent with the statutory language and accurately reflects Congressional intent. However, the Agencies' treatment of municipal bonds can be ameliorated.

We applaud the Agencies for confirming that the statutory phrase "an obligation issued by any State or political subdivision thereof"[99] does **not** include the obligations of an agency of any State or political subdivision thereof. However, we question why this important clarification was relegated to a footnote.[100] This is a significant distinction that should be made explicit in the body of the regulation itself, to emphasize to reviewing courts, compliance officers, Agency staff, and others that municipal agency bonds do not benefit from an exclusion from the Volcker Rule.

Further, it behooves the Agencies to recognize that non-agency municipal bonds, while excluded under the statute, warrant extra regulatory vigilance. Municipal bonds are often risky investments, especially as compared to debt issued at higher levels of government, such as the state or federal level. Indeed, we suspect that many municipal bonds would fail under the "risky assets" backstop. As discussed below, the Agencies should require an interpretive determination by the Federal Reserve before a banking entity is allowed to trade in municipal bonds.

Question 120. Should the Agencies adopt an additional exemption for proprietary trading in State or municipal agency obligations under section 13(d)(1)(J) of the BHC Act? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

The Agencies should *not* adopt an additional exemption for proprietary trading in State or municipal agency obligations under Section 13(d)(1)(J) of the BHC Act, as doing so would be conflict with Section 13(d)(1)(J)'s mandate to promote and protect the safety and soundness of banking entities and the financial stability of the United States. We remind the Agencies that, as per Congressional intent, Section 13(d)(1)(J) "sets an extremely high bar."[101]

Congress had the explicit opportunity to craft a municipal ("muni") agency bond exemption, and declined to do so, despite the exhortations of the banking lobby. Therefore, the Agencies should recognize this as a clear signal against the usage of their authority under Section 13(d)(1)(J) for this purpose.

Municipal bonds issued by state agencies and quasi-governmental authorities should NOT be exempted because they pose obvious risks to the banking system. The market for these bonds has not been properly regulated or controlled. In general, bankers have been able to exert too

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[99] 12 U.S.C. § 1851(d)(1)(A).
[100] *See* NPR at 68,875 n.165.
[101] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

much influence over municipal issuance. Banks own about half the bonds issued by municipal authorities,[102] and hold inordinate, unfettered and anti-competitive sway over such issuing authorities. The recent Wells Fargo muni debacle serves as a clarion example of the lack of effective regulation in the municipal bond market. Wells Fargo & Co. ("WF") agreed to pay $148 million to settle criminal charges and civil claims for conspiring to overcharge state and local governments on investments.[103] Essentially, WF fraudulently rigged the bidding for investment deals with local governments on at least 58 transactions from 1997 through 2005.[104] The settlement is the latest in a more than five-year investigation into how Wall Street banks conspired with local-government financial advisers to wangle excessive fees on investment deals by rigging auctions and carving the market up among themselves. J.P. Morgan Chase & Co., UBS AG and Bank of America Corp. previously settled similar cases.[105]

Other examples of bank misconduct in the muni sector abound, as the Agencies are doubtless aware. Stated plainly, an additional exemption for municipal agency bonds would be harmful to the banking system, as it would encourage banks to continue (and refocus) their attention on remote, highly unregulated markets in quasi-governmental securities that are already rife with abuse.

Further, an additional exemption for municipal agencies would strengthen the muni market, which encourages reckless state spending and reduces tax revenues. States across the U.S. have teetered on the edge of default because of inordinate bond issuances. California is a perfect example. California has nearly defaulted on its bonds and as a result has had to increase taxes and tuition, and cut back on services for residents. California is estimated to hold an approximate $25 billion dollar deficit, and some commentators expect the State's credit "to go from bad to terminal."[106]

<u>Question 121</u>. Should the Agencies adopt an additional exemption for proprietary trading in options or other derivatives referencing an enumerated government obligation under section 13(d)(1)(J) of the BHC Act? For example, should the Agencies provide an exemption for options or other derivatives with respect to U.S. government debt obligations? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

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[102] Alex Dunnin. *Volcker Rule Dramatics Continue*, Financial Standard Online, Nov. 23, 2011. http://www.financialstandard.com.au/news/view/12506675/.
[103] Michael B. Marois & Brendan A. McGrail. *California's $25 Billion Budget Gap Looms Over Revenue Notes: Muni Credit*, Bloomberg, Nov. 15, 2010, *available at* http://www.bloomberg.com/news/2010-11-15/california-s-25-billion-budget-gap-looms-over-revenue-notes-muni-credit.html.
[104] *Id.*
[105] *Bid Rigging, MF Global, Insider Trading, Cordray: Compliance*, Bloomberg Businessweek, Dec. 9, 2011. available at http://news.businessweek.com/article.asp?documentKey=1376-LVWQ6Z07SXKX01-3PEJRJA8CQEP73F2N5FO71HOQO.
[106] Marois & McGrail, *supra* note 103.

No, the Agencies should not adopt an additional exemption for proprietary trading in options or other derivatives in government obligations.

Question 122. Should the Agencies adopt an additional exemption for proprietary trading in the obligations of foreign governments and/or international and multinational development banks under section 13(d)(1)(J) of the BHC Act? If so, what types of obligations should be exempt? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

No, the Agencies should not adopt an additional exemption for proprietary trading in the obligations of foreign governments and/or international and multinational development banks. This could lead to more disasters like MF Global, which was precipitated by ostensibly "safe" foreign obligations. The Federal Reserve Bank cannot be the backstop for sovereign debt issues; that is, it cannot take on the responsibility of bailing out entire countries or central banking institutions.

Question 123. Should the Agencies adopt an additional exemption for proprietary trading in any other type of government obligations under section 13(d)(1)(J) of the BHC Act? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

No, an additional exemption for proprietary trading in any other type of government obligations would not promote the safety and soundness of banking entities and the financial stability of the United States.

Question 124. Are the definitions of "government security" and "municipal security" in sections 3(a)(42) and 3(a)(29) of the Exchange Act helpful in determining the proper scope of this exemption? If so, please explain their utility and how incorporating such definitions into the exemption would be consistent with the language and purpose of section 13 of the BHC Act.

We encourage the use of existing definitions in other areas of securities law to the extent that those definitions are consistent with the language and purpose of Section 13 of the BHC Act.

Question 125. Is the proposed rule's articulation of three categories of transactions on behalf of customers effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should any of the categories be eliminated? Should any additional categories be added? Please explain.

The categories appear to be effectively articulated and sufficiently clear, although we propose alternative language to one of the categories, as discussed in Question 126.

<u>Question 126</u>. Is the proposed rule's exemption of certain investment adviser, commodity-trading advisor, trustee or similar fiduciary transactions effective? What other types of relationships are or should be captured by the proposed rule's reference to "similar fiduciary relationships," and why? Is application of this part of the exemption to particular transactions sufficiently clear? Should any other specific types of fiduciary or other relationships be specified in the rule? If so, what types and why? What impact will the proposed rule's implementation of the exemption have on the investment adviser, commodity-trading advisor, trustee or similar fiduciary activities of banking entities? If such impacts are negative, how could they be mitigated or eliminated in a manner consistent with the purpose and language of the statute?

The language of § _.6(b)(2)(i)(A) does not appear in the statute, and does not fulfill congressional intent. The statute, in Section 619(d)(1)(D) allows for "[t]he purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) on behalf of customers" as a permitted activity. It does not state that these transactions on behalf of customers are to be performed by an investment adviser or by a commodity-trading advisor. Thus, as we outline in *Annexure B*, § _.6(b)(2)(i)(A) must be modified to **only** allow trading on behalf of customers where the banking entity is acting as "trustee, or in a similar fiduciary capacity for a customer."

<u>Question 127</u>. Is the proposed rule's exemption of riskless principal transactions effective? If not, what alternative would be more appropriate? Is the description of qualifying riskless principal activity sufficiently clear? If not, how should it be clarified? Should the riskless principal transaction exemption include a requirement that the banking entity must purchase (or sell) the covered financial position as principal at the same price to satisfy the customer buy (or sell) order, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee? Why or why not? Should the riskless principal exemption include a requirement with respect to the timeframe in which the principal transaction must be allocated to a riskless principal or customer account? Why or why not?

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

We suggest the following alternative definition of riskless principal transaction:

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

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

Question 128. Is the proposed rule's exemption of trading for separate accounts by insurance companies effective? If not, what alternative would be more appropriate? Does the proposed exemption sufficiently address the variety of customer-driven separate account structures typically used? If not, how should it address such structures? Does the proposed exemption sufficiently address the variety of regulatory or supervisory regimes to which insurance companies may be subject?

For further discussion, please see Question 134.

Question 130. Should the term "customer" be defined for purposes of the exemption for transactions on behalf of customers? If so, how should it be defined? For example, would an appropriate definition be (i) a continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction, (ii) a direct and substantive relationship between the banking entity and a prospective customer prior to the transaction, or (iii) a relationship initiated by the banking entity to a prospective customer for purposes of the transaction?

The need to identify and quantify which trades are in fact customer servicing and "customer-initiated"[107] is central to the implementation of this Rule. This can only be sensibly accomplished with a clear and specific definition of customer.

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

[107] FSOC Study, *supra* note 54, at 3.

explicit exclusion of Indirect from the definition of customer, is essential.

Question 131. Is the exemption for trading on behalf of customers in the proposed rule over- or under-inclusive? If it is under-inclusive, please discuss any additional activities that should qualify as trading on behalf of customers under the rule. What are the mechanics of the particular trading activity and how does it qualify as being on behalf of customers? Are there certain requirements or restrictions that should be placed on the activity, if permitted by the rule, to prevent evasion of the prohibition on proprietary trading? How would permitting the activity be consistent with the purpose and language of section 13 of the BHC Act? If the proposed exemption is over-inclusive, please explain what aspect of the proposed exemption does not involve trading on behalf of customers within the language and purpose of the statute.

The existing definition is excessively broad. It should be subject to the restrictions we have outlined in response to Questions 126 and 127, and should incorporate the explicit definition of customer, as discussed in Question 130. The definition is sufficiently broad as to easily accommodate all appropriate behavior, and should not be expanded in any way.

Question 132. Should any of the statutory requirements for the exemption be further clarified in the proposed rule? If so, how? Should any additional requirements be added? If so, what requirements and why?

The Agencies should implement the FSOC's recommendation to require certification from any regulated insurance company relying on the § _.6(c) exemption that the exemption is not being used as a means to evade the Volcker Rule's intent. Along the same lines, the Agencies should require periodic audits of any company relying on this exemption. Credit derivatives have many similarities to more traditional insurance products, and an exemption for insurance might be the driver for new insurance products that approximate proprietary positions while skirting the Volcker Rule's restrictions via the § _.6(c) exemption.

Question 134. For purposes of the exemption, are the insurance company investment laws, regulations, and written guidance of any particular State or jurisdiction insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States? If so, why?

While the various States may have relatively uniform insurance regulations by virtue of the coordinating impact of the National Association of Insurance Commissioners, certain states may be unduly lax in their actual enforcement of such regulations. Section _.6(c)(4) mirrors its statutory counterpart in permitting Federal banking agencies to consult with relevant insurance commissioners to waive the insurance exemption where actual enforcement is lax. However, the Proposed Rule does not create any timetable or schedule for these consultations. We recommend that the Agencies require that such consultations occur with every State at least once a year.

Question 136. Is the proposed rule's implementation of the foreign trading exemption effectively delineated? If not, what alternative would be more effective and/or clearer?

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

The criteria of § _.6(d)(1)(i) ensure that U.S.-domiciled banks do not simply ship their proprietary trading offshore, as has been done through entities like Edge Corporations in the past.[108] It is also important that holdings of U.S. banking entities that are **already** offshore, as they are for 59% of J.P. Morgan's fair-value derivative assets,[109] are not allowed to skirt the Volcker Rule. This is why is it so important for § _.6(d)(1)(i) to be retained in the Final Rule.

Section _.6(d)(1)(iii) is also critical because its absence may give foreign banks in the United States a near-term competitive advantage. This advantage is near-term because, while proprietary trading can often be profitable, it can also be the source of massive losses that can more than wipe out any profits that may have been made historically. But far more importantly, failing to retain § _.6(d)(1)(iii) in the Final Rule would mean that foreign banks could conduct proprietary trading through their U.S. offices and enjoy the benefits of being in the U.S. markets without being required to adhere to the rule of law in this country.

Question 138. Are the proposed rule's provisions regarding when an activity will be considered to have occurred solely outside the United States effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should any requirements be modified or removed? If so, which requirements and why? Should additional requirements be added? If so, what requirements and why?

The NPR's provisions on when the "purchase or sale occurs solely outside of the United States" are sufficiently clear and most effective. There are **no** requirements that should be removed. Any dilution of the current definition will only serve to provide safe harbor for banking entities

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[108] *See* Silla Brush, *Goldman Sachs Among Banks Fighting to Exempt Half of Swaps Books*, Bloomberg, Jan. 30, 2011, *available at* http://www.bloomberg.com/news/2012-01-30/goldman-sachs-among-banks-lobbying-to-exempt-half-of-swaps-from-dodd-frank.html ("Edge corporations, formed under the 1919 Edge Act on international banking, are bank subsidiaries for which Congress granted greater leeway to compete overseas. . . . Banks are seeking to have Edge corporations and other international affiliates exempted from Dodd-Frank rules when they have contracts with non-U.S. companies, Sullivan & Cromwell said in a letter on June 29.").

[109] *Id.* ("The Fed filings show that JPMorgan Chase & Co. had 59 percent of its $188 billion [in fair-value derivatives assets and liabilities] in overseas branches or international affiliates; Citigroup Inc. (C) had 53 percent of $122 billion; and Bank of America Corp. had half of $125 billion in non-U.S. operations in the same period.").

to evade the rules through clever structuring of affiliates, subsidiaries, Edge Corporations or other structures, so as to qualify for the § _.6(d)(1) exemption and thus subvert the Rule.

Question 139. Is the proposed rule's definition of "resident of the United States" effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Is the definition over- or under-inclusive? If so, why? Should the definition more closely track, or incorporate by reference, the definition of "U.S. person" under the SEC's Regulation S under the Securities Act? If so, why?

The definition of "resident of the United States" is neither over- nor under-inclusive, and we support the definition as written. It is sufficiently clear and thorough to prevent rule evasion on the part of the banking entities through the use of the exemption in § _.6(d)(1).

Question 140. Does the proposed rule effectively define a resident of the United States for these purposes? If not, how should the definition be altered?

We feel the definition of "resident of the United States" in § _.2(t) is well phrased and effective. We also feel it is sufficiently broad so as to prevent regulatory evasion on the part of the banking entities. It is crucial that all elements (1-8) of § _.2(t) be retained in the Final Rule, or there will be cases where the banking entities are able to evade the rules through the permitted foreign trading exemption.

Question 141. Should the Agencies use the authority provided in section 13(d)(1)(J) of the BHC Act to allow U.S.-controlled banking entities to engage in proprietary trading pursuant to section 4(c)(13) of the BHC Act outside of the United States under certain circumstances? If so, under what circumstances should this be permitted and how would such activity promote and protect the safety and soundness of banking entities and the financial stability of the United States?

The Agencies should **not** use the authority provided to them under section 13(d)(1)(J) to allow U.S.-controlled banking entities to engage in proprietary trading pursuant to Section 4(c)(13) of the BHC Act outside of the United States under any circumstances. Such an allowance would only serve to weaken the Rule and dilute statutory intent.

Question 142. Should the Agencies adopt any exemption from the prohibition on proprietary trading under section 13(d)(1)(J) of the BHC Act? If so, what exemption and why? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Metaphorically speaking, it might as well be asked if policemen should issue any exemption from the prohibition on murder to promote and protect the safety and soundness of civil society

in the United States. The addition of any more exemptions beyond the myriad loopholes already contained in the Proposed Rule would be farcical in appearance and likely disastrous in effect.

Question 143. Is the use of the proposed reporting requirements as part of the multifaceted approach to implementing the prohibition on proprietary trading appropriate? Why or why not?

We feel that the proposed reporting requirements are important to enforcement of the Rule. While we have strongly argued in earlier questions against any exclusion of repurchase and reverse repurchase agreements from the definition of trading account, should our request be denied, we feel it is imperative that **all** trading, be it excluded trading or not, should require quantitative measurements and risk reporting.

Question 144. Is the proposed gradual approach to implementing reporting requirements effective? If not, what approach would be more effective? For example, should the Agencies defer reporting of quantitative measurements until banking entities have developed and refined their compliance programs through the supervision and examination process? What would be the costs and benefits of such an approach?

We do **not** believe it would be effective to defer the reporting of metrics until the banking entities have developed their compliance programs. Banks already keep all or nearly all of the suggested metrics, and thus it should be straightforward to begin reporting on Day One. As we mentioned in Question 147, developing aggregate risk reports was one of the most universal reactions to the 2008 crisis.

That said, we understand that it may take a substantial amount of time to arrive at unified, accurate reporting on all metrics, but we do not feel that metrics should be stalled while waiting for perfect reporting.

Question 145. What role, if any, could or should the Office of Financial Research ("OFR") play in receiving and analyzing banking entities' reported quantitative measurements? Should reporting to the OFR be required instead of reporting to the relevant Agency, and would such reporting be consistent with the composition and purpose of OFR? In the alternative, should reporting to either (i) only the relevant Agency (or Agencies) or (ii) both the relevant Agency (or Agencies) and OFR be required? If so, why? What are the potential costs and benefits of reporting quantitative measurements to the OFR? Please explain.

We believe that the purview of the Office of Financial Research ("OFR") fits well with the need for conducting analysis on the quantitative measurements required by Volcker. We also feel that OFR is an excellent candidate to serve as a central data repository for these metrics. Because OFR is meant to be a point of access for all the Agencies, it would help intra-Agency

coordination of enforcement and record keeping if OFR were the central store for all metrics data. That said, we do not feel strongly that OFR must be the central store of metrics data. Rather, we simply feel that a centralized store must exist. Whether the repository is with OFR or one of the other Agencies is less relevant than ensuring that all Agencies can store and retrieve Volcker-related metrics at a single central location. We feel such a service would go very far toward ensuring optimal enforcement and monitoring.

We also want to ensure that staffing levels, budgets and other resources are sufficient to allow for effective execution. We are aware that this and other sections of the rule give numerous new mandates to the Agencies, and it is not clear to us that the current number of employees or fellows at the OFR is sufficient to manage the entire task of analyzing metrics. Additionally, if the OFR is the only group analyzing metrics, we are concerned that this will place an additional burden on OFR staff of coordinating with all enforcing Agencies. Thus, given the information available to us, our suggestion is that the burden of analyzing these metrics should be spread among the Agencies—with all analysis shared—to enable the best metrics-gathering possible given current resourcing.

We are optimistic about the OFR's ability to be funded through fees garnered from assessments on banking entities.[110] Since the Agencies receive variable funding through Congress, it seems that the most reliable approach would be for metrics analysis to be done through OFR, assuming it is able to assess regular fees on the banking entities, sufficient to fund the much-needed work of metrics analysis.

<u>Question 146</u>. Is there an alternative manner in which the Agencies should develop and propose the reporting requirements for quantitative measurements? If so, how should they do so?

Although we feel that the approach outlined is constructive, we feel additional steps should be taken to understand each banking entity's reported metrics. We suggest that the Agencies publish a benchmark portfolio of securities and require that each banking entity evaluates this portfolio according to their own risk measurements.

In order to understand how the risk measurements requested are calculated at various Banking Entities, the Agencies should choose a basket of securities (a benchmark portfolio whose contents are public information) that all Banking Entities must evaluate. This idea, first outlined

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[110] Jennifer Taub, *Great Expectations for the Office of Financial Research, in Will it Work? How Will We Know? The Future of Financial Reform* 24 (Roosevelt Institute 2010). *available at* http://www.rooseveltinstitute.org/sites/all/files/Will It Work Financial Research.pdf ("After two years of initial funding by the Fed, the OFR will secure permanent funding through assessments on large banks and other systemically important financial firms. However, under Dodd-Frank, it does not have control over the schedule. It is the Secretary of Treasury, in consultation with the Council, who will establish the assessments.").

in a letter to the Financial Times by Vikram Pandit,[111] will reveal differences in each entity's models and highlight to regulators any areas where models are being used to understate real risk.

Ideally, this approach would include not a single benchmark portfolio, but rather a series of benchmark portfolios for different instrument classes. Such an approach would deter evasion through manipulation of metrics.

Question 147. Does the proposed approach provide sufficient time for the development and implementation of effective reporting requirements? If not, what alternative approach would be preferable?

We feel strongly that the time allotted for compliance with the Volcker Rule and all related metrics reporting is more than adequate. Any suggestions to the contrary are likely to be politically motivated stalling tactics. It is our experience at many of the largest financial firms in this country and abroad that after the financial crisis of 2008, every firm that did not already have bank-wide aggregate risk metrics quickly began to draft implementation plans on how to make such monitoring and reporting a reality. In addition, given the industry-wide focus on risk in the wake of the crisis, many firms are busy creating low latency pre-trade risk systems, allowing for pre-trade checks on risk for themselves and direct market access systems.[112] Banks that claim to the Agencies that there is not sufficient time to develop and implement the reporting requirements are actively denying the simple fact that similar initiatives were launched, planned, and executed in the wake of the 2008 crisis.

Question 148. Should a trading unit be permitted not to furnish a quantitative measurement otherwise required under Appendix A if it can demonstrate that the measurement is not, as applied to that unit, calculable or useful in achieving the purposes of the Appendix with respect to the trading unit's covered trading activities? How might a banking entity make such a demonstration?

We are wary of allowing trading units to lobby for particular metrics to be removed from their reporting requirements. We feel that any decision made on skipping a particular metric should

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[111] Vikram Pandit, *Apples v Apples – a New Way to Measure Risk*, Financial Times, Jan. 10, 2012, *available at* http://www.ft.com/intl/cms/s/0/90bb724a-3afc-11e1-b7ba-00144feabdc0.html.

[112] Melanie Rodler, *Capital Markets Outlook 2012: Risk Tools*, Wall Street & Technology, http://www.wallstreetandtech.com/2012-outlook/risk-tools (last visited Feb. 5, 2012) ("Wall Street firms have been busily revamping their electronic trading platforms to ensure that they can perform pre-trade risk checks faster than ever before. . . .Bank of America Merrill Lynch recently announced BofAML Express, an ultralow-latency market access and risk control platform for U.S. equities that provides embedded risk controls with sub-10 microseconds of wire-to-wire latency. Morgan Stanley is using software to shave latency from its compliant direct-market-access platform, Speedway 3.0, which is live with at least five exchanges, including NYSE, ARCA, Nasdaq, BATS and the two Direct Edge exchange platforms. And Deutsche Bank is employing field-programmable gate array (FPGA)-based devices to lower latency for its risk checks.").

be standardized across banks by individual asset classes or products by OFR or one of the Agencies.

We believe OFR is well suited to set the standard. If allowances are made, they should not be at the request of a trading unit at a particular bank, but rather because the Agencies decide that a specific metric is not relevant or useful for a given asset class or product type. Failure to make such decisions for all banking entities could lead to obfuscation of metrics.

Question 149. Is the manner in which the Agencies propose to utilize the conformance period for review of collected data and refinement of the reporting requirements effective? If not, what process would be more effective?

Although we are generally in favor of faster and more aggressive implementation, it seems plausible that in this case further accelerating implementation might lead to an unmanageably large quantity of data being presented to the Agencies. If this quantity is large enough it may interfere with a meaningful response. So, while we urge faster implementation, we also urge the Agencies to exercise their discretion and ensure that no obfuscating "data deluge" occurs.

Question 150. Is the proposed $1 billion trading asset and liability threshold, which is also currently used in the Market Risk Capital Rules for purposes of identifying which banks and bank holdings companies must comply with those rules, an appropriate standard for triggering the reporting and record-keeping requirements of the proposed rule? Why or why not?

We believe that there are several amendments and clarifications that must be made to the calculation of the $1 billion threshold before it can be considered a useful trigger for reporting purposes. Specifically, we feel that the Agencies should ensure that *all assets and liabilities defined as trading assets for purposes of the Market Risk Capital Rule are included in the $1 billion standard* for triggering the Volcker Rule's reporting and record-keeping requirements.

Specifically, we feel that the NPR is not sufficiently clear about the definition of "trading assets and liabilities" for the purposes of calculating the $1 billion threshold. While there are numerous precedents for this definition, such as language in Form Y9-C's Schedule HC-D,[113] as well as in the Call Report's Schedule RC-D,[114] the Rule does not explicitly give a definition of "trading assets and liabilities" or point to any existing standard definition. We feel further clarity is required in the Final Rule, especially given our understanding that the NPR considers the $1

[113] Bd. of Governors of Fed. Reserve Sys., Form Y-9C, Schedule HC-D: Line Item Instructions for Trading Assets and Liabilities, *available at* http://www.federalreserve.gov/reportforms/forms/FR_Y-9C20111231_i.pdf.
[114] Fed. Deposit Ins. Corp., Schedule RC-D – Trading Assets And Liabilities, Reports of Condition and Income Instruction Book, *available at* http://www.fdic.gov/regulations/resources/call/crinst/2011-09/911RC-D_093011.pdf.

billion total to be calculated only for "covered trading activities."[115] We do not feel this is adequate.

The Agencies note that this $1 billion trading asset and liability threshold is the same quantitative standard used in the Market Risk Capital Rules for determining which bank holding companies and insured depository institutions must calculate their risk-based capital requirements for trading positions. But it does not clarify whether or not "trading assets and liabilities" will match the standard of the Market Risk Capital Rules, which define "trading assets and liability" by referring to the standard defined in the Call Report.[116] It is unclear from the NPR if that is the same standard that will be used for the threshold calculation. The comparison between the NPR's threshold and the Market Risk Capital's $1 billion threshold is not meaningful **unless** the assets counted in these two rules are equivalent.

Any failure to include the assets of currently excluded agreements such as repos, securities lending, and liquidity management plans in the $1 billion threshold calculation could lead to evasion of reporting. Banking entities may seek to financially engineer trades as structured repos, or simply claim they are "liquidity management" positions in order to fall underneath the $1 billion threshold, thereby avoiding reporting and record-keeping requirements.

Thus, we feel that the $1 billion threshold must be applied against all of the following positions, even though these positions are currently excluded from the definition of trading account[117] by the NPR:

- Positions arising under certain repurchase and reverse repurchase arrangements or securities lending transactions,
- Positions acquired or taken for bona fide liquidity management purposes, and
- Certain positions of derivatives clearing organizations or clearing agencies.

Since these positions will likely be large and have a significant impact on the capital calculation, it is prudent to include these assets and liabilities in the reporting requirement trigger.

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[115] *NPR at* 68.918 ("[A] banking entity must comply with the minimum standards specified in Appendix C of the proposed rule if: • **With respect to its covered trading activities**, it engages in any covered trading activities and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, (i) is **equal to or greater than $1 billion** or (ii) equals 10 percent or more of its total assets") (emphasis added).

[116] 12 C.F.R. part 225, app. B to pt. 3 at § 1(b) n.2 ("Trading activity means the gross sum of trading assets and liabilities as reported in the bank's most recent quarterly Consolidated Report of Condition and Income (Call Report)").

[117] Please see our response to Questions 30-45 for why the dangerous exclusions of repos, securities lending and liquidity management plans from the definition of trading account should be removed in the Final Rule.

To ensure consistency and to eliminate reconciliation issues between the Volcker rule definition of trading account and the Market Risk Capital Rules definition of trading account, the Market Risk Capital Rule definition should prevail for triggering the reporting requirement.

The Calculation Period must be Redefined

The calculation period used to determine the trading asset and liability-reporting trigger is inadequate. These positions will be monitored and calculated on a daily basis at the banks. It is imprudent to measure compliance based on just four days over the previous year.

The $1 billion position limit must be modified to reflect a more accurate measure of the positions taken on the remaining 361 days. Failure to do so could lead to accounting legerdemain to allow a larger banking entity to fall underneath the $1 billion threshold.

Market Risk Capital Rules may Understate the Size of the Trading Account Exposure

Consensus on the measurement of trading account size does not currently exist among the global regulators. The Market Risk Capital Rules referred to in the trading account definition in § _.3 refer to the current *proposed* Market Risk Capital rules. There is considerable debate among regulators and practitioners about appropriate measurement methodologies for structured products like credit default swaps. Therefore, should the Agencies decide not to require reporting across all banking entities, the final reporting trigger should be set low enough to compensate for these measurement shortcomings.

If not, what alternative standard would be a better benchmark for triggering the reporting and recordkeeping requirements?

We suggest an alternative that includes the following elements:

- An additional, lower reporting trigger threshold should be established to require reporting if the portfolio of trading assets contains any trading asset that relies on a valuation model, rather than an independent price verification to assign a balance sheet value.
- The values of assets included in the reporting trigger calculation must be refined to reflect actual trading account exposures, rather than trading account balance sheet valuations.
- Adjustments to the Market Risk Capital Rule trading account accounting measurements must be made to appropriately quantify the exposure of so-called Tier 3 Assets (mark-to-model valuations).
- Exposures to forwards and futures must be appropriately included in the threshold. A large futures position will be reported at the current value of the open futures position. The size of the open position does not appear on the balance sheet. As a result, it is conceivable that an open futures position

exceeding $1 billion would not be included in the current threshold calculation.

Should all of the above alternatives be included in the Final Rule, we would support a $1 billion total requirement to trigger reporting and record keeping. We would support this because, if all trading assets (excluded from the definition of trading account or otherwise) are included in that total, $1 billion in assets globally is a sufficiently small sum that such a banking entity should not pose enough of a threat to the financial stability of the United States as to require detailed monitoring of metrics.

Question 152. Should the proposed $1 billion trading and asset liability threshold used for triggering the reporting and recordkeeping requirements adjust each time the thresholds for complying with the Market Risk Capital Rules adjust, or otherwise be adjusted over time? If not, how and when should the numerical threshold be adjusted?

We do not believe the $1 billion threshold should be adjusted each time the Market Risk Capital Rules adjust. The negotiation of the Market Risk Capital rules is a separate process, and while those rules may be useful in defining standards for purposes of this rulemaking, they are distinct from the statutory requirements underlying these rules. The statute makes no reference to the Market Risk Capital Rules process. An automatic update to the Volcker Rule based on changes in the Capital rules is unwarranted and imprudent.

The rules should only need to be changed in order to account for the public comment process. An automatic update of the threshold would only serve to undermine that process.

Question 153. Should all banking entities be required to comply with the reporting and recordkeeping requirements set forth in Appendix A in order to better protect against prohibited proprietary trading, rather than only those banking entities that meet the proposed $1 billion trading asset and liability threshold? Why or why not?

As discussed in Question 150, we believe that the $1 billion threshold would be sufficient should all of our additions and amendments be incorporated. If the Agencies do not incorporate our suggested revisions to the threshold calculation, we would suggest that all banking entities be required to comply with the reporting and record keeping requirements.

Question 154. Should banking entities that fall under the proposed $1 billion trading asset and liability threshold be required to comply with the reporting and record-keeping provisions for a pilot period in order to help inform judgment regarding the levels of quantitative measurements at such entities and the appropriate frequency and scope of examination by the relevant Agency for such banking entities? Why or why not?

We support the suggestion that all banking entities participate in reporting and record keeping during a pilot period. As discussed in Question 147, most of the quantitative data requested is already available at all banks. Much of that data is currently used by banks to prepare their capital requirement reporting as well as manage their exposures.

Question 155. Are the ways in which the proposed rule would make use of reported quantitative measurements effective? If not, what uses would be more effective?

We see the uses of reported quantitative measurements as generally comprising three main goals, each of which will reflect varying degrees of effectiveness:

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

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

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

Should the proposed rule instead use quantitative measurements as a dispositive tool for identifying prohibited proprietary trading? If so, what types of quantitative measurements should be employed, what numerical amount would indicate impermissible proprietary trading activity, and why?

There are serious limits to the capabilities of these measurements, and the potential for abuse and manipulation of input data is significant. We urge the Agencies to always take a holistic view of risky activities, and never rely on these measurements as dispositive tools for anything.

Should the quantitative measurements play a less prominent role than proposed in identifying prohibited proprietary trading and why?

Despite their various shortcomings, we are strongly in support of the current requirements for quantitative measurements, and do **not** feel that their role should be in any way diminished. Without the reporting of these measurements, we believe there would be significant evasion of the Volcker Rule by the banking entities.

Question 157. Is the proposed definition of "trading unit" effective? Is it sufficiently clear? If not, what alternative definition would be more effective and/or clearer? Should the definition include more or less granular levels of activity? If so, what specific criteria should be used to determine the appropriate level of granularity?

Our major concern lies with the possibility of the Volcker Rule allowing for an inappropriately large trading unit.

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

A more effective alternative definition would be to use the criteria listed in footnote 191 of the Supplementary Information. Footnote 191 defines the trading unit with sufficient granularity. The Rule needs to explicitly incorporate those criteria in the final definition.

Question 159. Is the proposed rule's requirement that quantitative measurements be reported at multiple levels of organization, including for quantitative measurements historically reported on an aggregate basis (e.g., Value-at-Risk ("VaR") or Stress VaR) appropriate?

We believe that it is appropriate and correct that the NPR requires measurements at multiple levels of organization.

We suspect that the banking entities will argue that quantitative measurements such as VaR have limited utility at a disaggregated level, and that requiring the analysis at that level will impose an unnecessary and costly burden on them. We further suspect that they may argue that VaR as a metric is flawed. While both arguments have merit in some other contexts, we believe they are irrelevant for purposes of this rule making.

Desk-level VaR is extremely useful to the regulators as an indicator of the existing risk sensitivity on trading and market making desks. As a regulatory tool, VaR is useful as a measure of exposure to market risks.

Since there should be zero exposure to non-permitted trading activity, any significant VaR on a trading desk should be interpreted by the regulators as a clear, early warning signal that something is amiss.

In an imperfect world, VaR still serves the useful purpose of immediately alerting regulators to compare the underlying sensitivities (which will be reported to the regulators concurrent with the VaR statistics) against the Rule's limitations.

If not, what alternative would be more effective? What burdens are associated with such a requirement? How might those burdens be reduced or limited? Please quantify your answers, to the extent feasible.

The burden associated with the requirement to provide the Appendix A quantitative measures will be borne by those banks that benefit from the Volcker Rule's permitted activities. For legitimate market makers with near-zero market risk, or banks that do not participate in proprietary trading activity, calculating VaR at a desk level will impose only a marginal additional cost. The additional compliance costs are outweighed by the benefits compliant banks receive in the form of explicit and implicit government guarantees.

Question 160. Is the proposed tiered approach to identifying which banking entities and trading units must comply with the reporting requirements effective? If not, what alternative would be more effective?

Our concerns with the current approach are mainly focused on the $1 billion threshold calculation, as well as the difficulty of valuing derivatives assets for the purpose of the reporting trigger. For further discussion, please see our answers to Questions 150 and 162.

Does the proposal strike the appropriate balance between the potential benefits of the reporting requirements for monitoring and assuring compliance and the potential costs of those reporting requirements?

The appropriate balance has been reached between benefits and costs. In fact, based on the set of quantitative measures required to be reported, there should only be a marginal cost to the banks to provide this information to the regulators, as most quantitative measures are already produced at the banks.

If not, how could that balance be improved? Should the relevant gross trading assets and liabilities threshold for any category be increased or reduced? If so, why?

We do not believe that any thresholds should be increased. For a further discussion of our concerns with the existing trading assets and liabilities threshold, please see our answer to Question 150.

Question 161. Should the $1 billion and $5 billion gross trading assets and liabilities thresholds used to identify the extent to which a banking entity is required to furnish quantitative measurements be increased or reduced? If so, why?

For further discussion, please see Question150.

Should the thresholds be indexed in some way to account for fluctuations in capital markets activity over time? If so, what would be an appropriate method of indexation?

We do not feel that it is necessary to index the thresholds to account for fluctuations in capital markets activity.

Question 162. Is the proposed $5 billion trading asset and liability threshold an appropriate standard for triggering enhanced reporting requirements under the proposed rule? Why or why not? If not, what alternative standard would be a better benchmark for triggering enhanced reporting requirements?

All banks that meet the $1 billion trading asset and liability threshold should by required to conduct enhanced reporting. This is important because, even in the criteria set by the Call Report's Schedule RC-D, credit default swaps and other derivatives may be valued substantially lower than their inherent risk.[118] For example, a $100 million credit default swap could have a "fair value" of only $75,000. Thus, neither the $1 billion nor the $5 billion threshold is meaningful should the banking entity hold a substantial portion of its assets in derivatives the "fair value" calculation of which may not properly reflect the inherent risk involved.

Question 163. Should the proposed $5 billion trading and asset liability threshold used for triggering enhanced reporting requirements under the proposed rule be subject to adjustment over time? If so, how and when should the numerical threshold be adjusted?

The $5 billion trading and asset liability threshold for enhanced reporting should not be subject to adjustment over time.

Question 164. Is there a different criterion other than gross trading assets and liabilities that would be more appropriate for identifying banking entities that must furnish

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[118] Fed. Deposit Ins. Corp., *supra* note 114, at 5. Item 11. ("Derivatives with a positive fair value."). *See also id.* at Item 14 ("Derivatives with a negative fair value.").

quantitative measurements? If so, what is the alternative criterion, and why would it be more appropriate?

If the Agencies account for the concerns we raise in Question 162 about the difficulties of valuing derivatives, and our request for a strict definition of "trading assets and liabilities" as discussed in Question 150, the current trigger for enhanced reporting will be adequate.

Are worldwide gross trading assets and liabilities the appropriate criterion for foreign-based banking entities? If not, what alternative criterion would be more appropriate, and why?

Worldwide gross trading assets and liabilities are absolutely the correct criterion for foreign-based banking entities. Foreign affiliates must face the same constraints on their U.S. affiliates as their U.S. competitors do if they want to conduct business in the U.S. and with U.S. customers.

Question 165. Are the quantitative measurements specified for the various types of banking entities and trading units effective? If not, what alternative set of measurements would be more effective? For each type of trading unit, does the proposal strike the appropriate balance between the potential benefits of the reporting requirements for monitoring and assuring compliance and the potential costs of those reporting requirements? If not, how could that balance be improved?

The specified measurements are effective because they are the most indicative standard market metrics available today. They do contain numerous and extensive shortcomings, which must be tolerated in the absence of superior risk methodologies.

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

Question 166. Should banking entities with gross trading assets and liabilities between $1 billion and $5 billion also be required to calculate and report some of the quantitative measurements proposed for banking entities meeting the $5 billion threshold for purposes of assessing whether the banking entity's underwriting, market making, risk-mitigating hedging, and trading in certain government obligations activities involve a material exposure to high-risk assets or high-risk trading strategies?

Yes.

If so, which quantitative measurements and why? If not, why not?

These banking entities should be additionally required to furnish:

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

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

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

Question 167. Is the proposed frequency of reporting effective? If not, what frequency would be more effective? Should the quantitative measurements be required to be reported quarterly, annually, or upon the request of the applicable Agency and why?

The reporting frequency is effective and should not be reduced in any way.

Question 168. Are the proposed quantitative measurements appropriate in general? If not, what alternative(s) would be more appropriate, and why? Should certain quantitative measurements be eliminated, and if so, why? Should additional quantitative measurements be added? If so, which measurements and why? How would those additional measurements be described and calculated?

The proposed quantitative measurements are generally appropriate for certain liquid and transparent trading activities. We have some specific concerns with methodology, which will be addressed in the following questions. Many of the measurements are not meaningful in illiquid markets (Spread P&L, for example) or for derivatives instruments (for instance, Inventory Turnover), and these products should be considered prohibited, as they are unable to provide even the most basic reliable data.

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

We also recommend that VaR back-testing results be added to the list of required metrics. This would provide a more robust measure than the proposed VaR Exceedance requirement. These results compare actual profit and loss to VaR estimates and can be used by the regulators to evaluate the effectiveness of the VaR model for capital calculation purposes. These results should be incorporated into the quantitative measures requirement to help the regulators determine the reliability of the VaR data.

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

Question 169. How many of the proposed quantitative measurements do banking entities currently utilize? What are the current benefits and costs associated with calculating such quantitative measurements? Would the reporting and recordkeeping requirements proposed in Appendix A for such quantitative measurements impose any significant, additional benefits or costs?

Banking entities currently utilize, or calculate the necessary data to utilize all of the listed quantitative measurements. The reporting and recordkeeping requirements will cause no real additional costs, but the increased priority and attention to quality demanded by this Rule will clearly produce significant benefits for the banking entities.

Question 170. Which of the proposed quantitative measurements do banking entities currently not utilize? What are the potential benefits and costs to calculating these quantitative measurements and complying with the proposed reporting and recordkeeping requirements? Please quantify your answers, to the extent feasible.

For further discussion, please see Question 169.

Question 171. Is the scope and frequency of required reporting appropriate? If not, what alternatives would be more appropriate? What burdens would be associated with reporting quantitative measurements on that basis, and how could those burdens be reduced or eliminated in a manner consistent with the purpose and language of the statute? Please quantify your answers, to the extent feasible.

A general inconsistency is found in the NPR's recordkeeping requirement, which states:

> Covered banking entities must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program. A covered banking entity must retain these records for a period that is no less than 5 years in a form that allows it to promptly produce such records to [Agency] on request.[119]

We propose this requirement be amended to 6 years, such that it matches the New York State Statute of Limitations for civil actions relating to contracts and fraud.[120]

Question 172. For each of the categories of quantitative measurements (e.g., quantitative measurements relating to risk management), what factors should be considered in order to further refine the proposed category of quantitative measurements to better distinguish prohibited proprietary trading from permitted trading activity? For example, should the timing of a calculation be considered significant in certain contexts (e.g., should specific quantitative measurements be calculated during the middle of a trading day instead of the end of the day)? Please quantify your answers, to the extent feasible.

For further discussion, please see Question 174.

Question 173. In light of the size, scope, complexity, and risk of covered trading activities, do commenters anticipate the need to hire new staff with particular expertise in order to calculate the required quantitative measurements (e.g., collect data and make computations)? Do commenters anticipate the need to develop additional infrastructure to obtain and retain data necessary to compute the proposed quantitative measurements? Please explain and quantify your answers, to the extent feasible.

The relevant infrastructure is already in place, and minimal additional resources should be required to implement the reporting of quantitative measures in this Rule. For further discussion, please see Question 174.

Question 174. For each individual quantitative measurement that is proposed:

Is the use of the quantitative measurement to help distinguish between permitted and prohibited trading activities effective? If not, what alternative would be more effective? Does the quantitative measurement provide any additional information of value relative to other quantitative measurements proposed?

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[119] NPR at 68.936.
[120] *See* N.Y. Civ. Prac. L. & R. § 213 (2012).

Generally, we agree that the quantitative measures defined in Appendix A are useful for distinguishing between permitted and prohibited activities. However, we have concerns about the specific measures that should be addressed in the Final Rules.

VaR, Stress VaR, and VaR Exceedance

We have a number of criticisms of current Value-at-Risk measurements and methodologies, but in general we recognize that this metric is ubiquitous because a superior alternative has not been developed.

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

VaR gives a *very* high level indication of the level of risk held by a banking entity at a given time. In theory, generally high levels of risk, or abnormalities in risk profiles, may be indicative of inappropriate warehousing of risk, and therefore of proprietary activity. In general, however, we expect this measure to indicate a general snapshot of risk levels for the purpose of comparison within the industry.

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

Risk Factor Sensitivities Risk and Position Limits

Risk Factor Sensitivities will be the most useful tool for identifying the accumulation of risk in different areas of a banking entity.

It is unclear to us how Position Limits are in fact a quantitative measurement, and not a description of a banking entity's internal risk policies. This may be an important piece of information for the Agencies, but it is not an overly important piece of data with respect to identifying proprietary trading activities.

Comprehensive Profit and Loss, and Portfolio Profit and Loss

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

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

Spread Profit and Loss
Spread Profit and Loss is **not** effective as defined. This may be a useful metric in very liquid markets, but we see the NPR's potential reliance on this particular quantitative measurement within illiquid markets as an indication of a very serious lack of understanding of how such markets behave.

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

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

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

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

Comprehensive Profit and Loss Attribution
This is a good, common sense metric that will serve to provide a general overview of a banking entity's trading and risk activities.

Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss
These are good, common sense metrics that may serve to highlight areas requiring further investigation, since high P&L volatility may indicate a deviation from traditional client-related activities.

Unprofitable Trading Days based on Comprehensive P&L, and on Portfolio P&L

These are good, common sense metrics that may serve to highlight areas requiring further investigation, since a significant number of unprofitable trading days may indicate a deviation from traditional client-related activities.

Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss
This is a useless measure as currently defined, as explained below.

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

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

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

Because adequate data often simply does not exist for illiquid and many OTC products, and it follows that proper risk management and oversight is impossible for such instruments, they should not be permitted as trading activities in covered banking entities.

Is the use of the quantitative measurement to help determine whether an otherwise-permitted trading activity is consistent with the requirement that such activity must not result, directly or indirectly, in a material exposure by the banking entity to high-risk assets and high-risk trading strategies effective? If not, what alternative would be more effective?

The following metrics will be useful in possibly alerting the Agencies to excessive risk warehousing across products, which could potentially be useful for the purpose of identifying high-risk assets and trading strategies:

- VaR, Stress VaR, and VaR Exceedance
- Risk Factor Sensitivities
- Comprehensive Profit and Loss, and Portfolio Profit and Loss
- Comprehensive Profit and Loss Attribution
- Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss
- Comprehensive P&L to Volatility Ratio, and Portfolio P&L to Volatility Ratio

- Unprofitable Trading Days based on Comprehensive P&L, and on Portfolio P&L
- Inventory Aging, and Inventory Turnover

What factors should be considered in order to further refine the proposed quantitative measurement to better distinguish prohibited proprietary trading from permitted trading activity? For example, should the timing of a calculation be considered significant in certain contexts (e.g., should specific quantitative measurements be calculated during the middle of a trading day instead of at the end of the day)?

Risk Factor Sensitivities, Portfolio Profit and Loss
Because it may be possible to disguise risk factor sensitivities at particular calculation times, we suggest several risk factor sensitivity snapshots be taken throughout the day, with an average value reported at the end of the day to the Agencies.

The Portfolio P&L associated with such sensitivities should always be reported in conjunction with them.

If the quantitative measurement is proposed to be applied to a trading unit that is engaged in activity pursuant to §§ _.4(a), __.5, or __.6(a) of the proposed rule, is the quantitative measurement calculable in relation to such activity?

Spread Profit and Loss
Spread Profit and Loss will not be meaningfully calculable in relation to any activity in illiquid assets.

Is the quantitative measurement useful for determining whether underwriting, risk mitigating hedging, or trading in certain government obligations is resulting, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies?

The relevant quantitative measurements are calculable in relation to such activity, and are able to provide general guidance regarding high risk-assets or trading strategies. There are serious limits to the capabilities of these measurements, however, and they should never be considered to be dispositive indicators of high-risk assets or high-risk trading strategies.

Is the description of the quantitative measurement sufficiently clear? What alternative would be more appropriate or clearer? Is the description of the quantitative measurement appropriate, or is it overly broad or narrow? If it is overly broad, what additional clarification is needed? Should the Agencies provide this additional clarification in the appendix's description of the quantitative measurement? If the description is overly

narrow, how should it be modified to appropriately describe the quantitative measurement, and why?

With the exceptions noted below, we believe the description of the quantitative measures is sufficiently clear.

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

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

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

Is the general calculation guidance effective and sufficiently clear? If not, what alternative would be more effective or clearer? Is more or less specific calculation guidance necessary? If so, what level of specificity is needed to calculate the quantitative measurement? What are the different calculation options and methodologies that could be used to reach the desired level of specificity? What are the costs and benefits of these different options? If the proposed calculation guidance is not sufficiently specific, how should the calculation guidance be modified to reach the appropriate level of specificity? For example, rather than provide this level of specificity in proposed Appendix A, should the Agencies instead make each banking entity responsible for determining the best method of calculating the quantitative measurement at this level of specificity, based on the banking entity's business and profile, which would then be subject to supervision, review, or examination by the relevant Agency?

The specific guidance in the proposed Appendix A is adequate, subject to some modifications to the definitions that we discuss below. The Agencies should require each banking entity to

provide the metrics defined based on defined standards, as in the proposed Appendix A. It should not be left to each banking entity to determine the best method of calculating the quantitative measurement. We would expect the Appendix A standards to be refined as a result of this public comment process, but the statute is clear and the FSOC Study supports the intent that the regulators would define a common set of standard metrics. Over time, the Agencies will refine the measures as the data is assessed.

VaR, Stress VaR, and VaR Exceedance

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

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

Furthermore, we caution the Agencies against providing inappropriate freedom to banking entities in their development of metrics regimes. Not only will this promote extremely incomparable data, but additionally this is an area where banking entities have proven to be inadequate with respect to internal governance.

Comprehensive Profit and Loss, and Portfolio Profit and Loss

The Calculation Guidance for Comprehensive P&L contains a serious error:

> *General Calculation Guidance:* Comprehensive Profit and Loss generally should be computed using data on the value of a trading unit's underlying holdings, the prices at which those holdings were bought and sold, and the value of any fees, commissions, sales credits, **spreads**, dividends, interest income and expense, or other sources of income from trading activities, whether realized or unrealized.[121]

"Spreads" is an undefined and meaningless word in this capacity and should be removed. We would like to note that the description of Comprehensive P&L in Appendix A states that this metric "should generally equal the sum of the trading unit's (i) Portfolio Profit and Loss and (ii) Fee Income," but the word "spreads" is not included in the description of either of those component parts.

Spread Profit and Loss

[121] NPR at 68.958 (emphasis added).

Outside of the most liquid and transparent markets, the Calculation Guidance for this measure is largely nonsensical. The concept of "turnover" is not applicable to most derivatives markets. Further, there is no practical way to accurately and consistently identify who initiated a given trade for the purposes of this calculation, and the guidance for bid/offer spreads in illiquid markets amounts to "just make it up."

Of course, the nature of illiquid markets is that there is no way to collect good data about trading patterns. The idea communicated by this Guidance is that the Agencies would prefer garbage to be reported, as opposed to nothing at all. We see this as yet another example of the pure impracticality of allowing banking entities to trade illiquid products within the framework of this Rule.

Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss
30 days or even 90 days is insufficient for estimating these statistics, which can be demonstrated by any computational package thus: Take a Student-t distribution with say 3 degrees of freedom, take a sample size of 30 or 60 or 90, and compute the sample skewness and kurtosis. Do this 10,000 times for each window length and view the histogram of the resulting estimates. It will be observed that there is not a tight band around the "true" value.

We suggest using 2 years of daily data as an appropriate calculation period for these measures.

Comprehensive Profit and Loss Attribution
The mention of "customer spreads, bid-ask spreads" is extremely unclear in the Guidance. "Customer spreads" is neither an understood concept, nor is its intended meaning included anywhere in this Proposed Rule. Further, we are unclear how "bid-ask spreads" would be meaningfully separated from either trade P&L (or P&L resulting from closed-out buy/sell pairs of identical transactions) or mark-to-market gains or losses from new trading positions on the books. We propose the removal of both of these terms from the Calculation Guidance.

If the proposed calculation guidance is overly specific, why is it too specific and how should the guidance be modified to reach the appropriate level of specificity? Is the general calculation guidance for the measurement consistent with how banking entities currently calculate the quantitative measurement, if they do so? If not, how does the proposed guidance differ from methodology currently used by banking entities? What is the purpose of the current calculation methodology used by banking entities?

The general Calculation Guidance is consistent with current industry practice for managing risk, preparing profit and loss attribution, and preparing financial reports. Additionally, most of these metrics are required as evidence of the effectiveness of the internal controls around financial reporting.

What operational or logistical challenges might be associated with performing the calculation of the quantitative measurement and obtaining any necessary informational inputs?

Realistically, there should be no logistic or operational challenges with respect to these measurements, beyond those that already exist in banking entities. We would like to reiterate that all of the relevant data is already being collected and analyzed within banking entities, and this rule's requirements should be exceedingly easy to meet.

We can see a number of potential complications due to the poor design or implementation of current practices (for instance, varying VaR calculation methodologies across business units in a banking entity). The Agencies must be diligent in ensuring they receive the highest quality data from banking entities in light of such challenges.

Is the quantitative measurement not calculable for any specific type of trading unit? If so, what type of trading unit, and why is the quantitative measurement not calculable for that type of trading unit? Is there an alternative quantitative measurement that would reflect the same trading activity but not pose the same calculation difficulty? Are there particular challenges to documenting that a specific quantitative measurement is not calculable?

We do not believe any of the quantitative measures are not calculable by any of the firms engaged in the activities permitted under the statute.

Is the quantitative measurement substantially likely to frequently produce false negatives or false positives that suggest that prohibited proprietary trading is occurring when it is not, or vice versa? If so, why? If so, what alternative quantitative measurement would better help identify prohibited proprietary trading?

We have proposed that **none** of these quantitative measurements should be seen as, or understood to be, a dispositive tool for identifying prohibited proprietary activity. Therefore, the problems of false-positives or false-negatives should not be an issue.

Taken together, these quantitative measurements serve to provide a general overview of the types of risks and activities conducted at a banking entity, and we again caution the Agencies to maintain realistic expectations about what information these measures can provide.

Should the quantitative measurement better account for distinctions among trading activities, trading strategies, and asset classes? If so, how? For example, should the quantitative measurements better account for distinctions between trading activities in cash and derivatives markets? If so, how? Are there any other distinctions for which the quantitative measurements may need to account? If so, what distinctions, and why?