Occupy the SEC

http://www.occupythesec.org

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Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in and Relationships With, Hedge Funds and Private Equity Funds (RIN 1557-AD44; RIN 7100 AD 82; RIN 3064-AD85; RIN 3235-AL07)

Dear Sirs and Madam:

Occupy the SEC[1] submits this comment letter in response to the above-mentioned regulatory agencies' ("Agencies") notice of Proposed Rulemaking ("NPR", "Proposed Rule")[2] implementing Section 619 of the Dodd-Frank Act ("the Act").[3]

Occupy the SEC is a group of concerned citizens, activists, and financial professionals with decades of collective experience working at many of the largest financial firms in the industry. Together, we make up a vast array of specialists, including traders, quantitative analysts, compliance officers, and technology and risk analysts. Like much of the 99%, we have bank deposits and retirement accounts that are in need of protection through vigorous enforcement of

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[1] Occupy the SEC (http://occupythesec.org) is a group within the New York-based Occupy Wall Street ("OWS") protest movement. This letter represents the opinion of our group's members, and does not represent the viewpoints of OWS as a whole. Our members include Akshat Tewary, Alexis Goldstein, Corley Miller, George Bailey, Caitlin Kline, Elizabeth K. Friedrich, Eric Taylor, and others.

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

[3] 12 U.S.C. § 1851 (2011).

the Volcker Rule. Our experiences working inside the financial industry have informed our answers to the questions proposed, making us well-suited to understand and anticipate how the proposed implementation, should it stand, will affect us and the rest of the general public.

The United States aspires to democracy, but no true democracy is attainable when the process is determined by economic power.[4] Accordingly, Occupy the SEC is delighted to participate in the public comment process for the implementation of Section 619 of the Dodd-Frank Act by the SEC, Federal Reserve, OCC and FDIC ("the Agencies"). This country's governing principles of transparency and due process mandate that any rules implemented by our regulators comport with the democratically-elected legislature's intention to protect the people from the widespread banking abuses and excesses of the recent past. We believe the Volcker Rule is important to the future of the banking industry and, if strongly enforced, will help move our financial system in a more fair, transparent, and sustainable direction. Prohibiting banking entities from engaging in proprietary trading and banning their sponsorship of covered funds are key elements to regulating the financial system and giving force to the Dodd-Frank Act. At its core, the Volcker Rule seeks to make sure that if a banking entity fails, it does not bring down the whole system with it. We appreciate the momentous challenges that the Agencies continue to face in effectively implementing the Rule, and we present these comments to assist them in their task.

This letter contains a summary of our positions. *Annexure A* hereto contains more detailed answers to 244 of the 395 questions asked by the Agencies. Any questions that remain unanswered in *Annexure A* should be interpreted by the Agencies as our suggestion that the applicable provision in the Proposed Rule remain unchanged. *Annexure B* contains a proposed markup of various sections of the Text of the Proposed Rule, and *Annexure C* contains a proposed markup of the Commentary Regarding Identification of Permitted Market Making–Related Activities, which appeared as Appendix B to the Proposed Rule.

[4] Occupy Wall Street, Declaration of the Occupation of New York City (2011), http://www.nycga.net/resources/declaration/.

I. INTRODUCTORY COMMENTS

Proprietary trading by large-scale banks was a principal cause of the recent financial crisis,[5] and, if left unchecked, it has the potential to cause even worse crises in the future. In the words of a banking insider, Michael Madden, a former Lehman Brothers executive:

> Proprietary trading played a big role in manufacturing the CDOs and other instruments that were at the heart of the financial crisis. . . . If firms weren't able to buy up the parts of these deals that wouldn't sell . . . the game would have stopped a lot sooner.[6]

The interconnectedness of banks under the shadow banking system had the effect of magnifying one bank's proprietary trading losses (e.g., Lehman Brothers) and transferring them across the market as a whole. Lobbyists' exhortations notwithstanding, proprietary trading by government-backstopped banks is a fundamentally speculative and risky phenomenon that must be circumscribed.

During the legislative process, the Volcker Rule was woefully enfeebled by the addition of numerous loopholes and exceptions. The banking lobby exerted inordinate influence on Congress and succeeded in diluting the statute, despite the catastrophic failures that bank policies have produced and continue to produce.[7] Nevertheless, the Volcker Rule, in its current statutory form still has the potential to rein in certain speculative trading practices by banking entities that enjoy ready access to customer deposits and virtually limitless funding through various Federal Reserve programs. We encourage the Agencies to stand strong against the flood of deregulatory pressure that they have and will continue to face in connection with their implementation of the Volcker Rule. A vigorously implemented and enforced Volcker Rule would serve as insurance against the need for future bank bailouts funded by taxpayers.[8] The Agencies must take advantage of this historic opportunity to protect the financial position of the average person living in the United States.

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[5] *See, e.g.*, Jeff Merkley, U.S. Senator and Carl Levin, U.S. Senator, *Making the Dodd—Frank Act Restrictions on Proprietary Trading & Conflicts of Interest Work*, Roosevelt Institute, *available at* http://www.rooseveltinstitute.org/sites/all/files/Will_It_Work_Proprietary_Trading.pdf. This view has been echoed across academia. For instance, Jeremy Berkowitz, a finance professor at the University of Houston noted that "[t]o a certain extent, proprietary trading was the key driving force that was behind the disaster. For whatever the reason, Lehman and other banks decided to take positions in mortgages, and when those positions went south, so did the firms." Stephen Gandel, *Is Proprietary Trading Too Wild for Wall Street?*, Time, Feb. 5, 2010, *available at* http://www.time.com/time/business/article/0,8599,1960565,00.html#ixzz1kuiacUK. *See also* Gerald Epstein, The Volcker Rule: Rule Implementation Issues and Study Guide, SAFER Policy Brief (Oct. 4, 2010) ("Appropriate, forceful implementation of these provisions is crucial for helping to avoid future economic crisis.").

[6] Gandel, *supra* note 5.

[7] *See* Occupy Wall Street, *supra* note 4.

[8] 156 Cong. Rec. S5893 (daily ed. July 15, 2010) (statement of Sen. Conrad).

A. The Agencies' Lax Regulatory Posture

The Agencies have been universally lambasted, by banks, by advocacy groups, by Congress, and by the media, for promulgating a Proposed Rule that is a 500-page web of complexity.[9] Even former Federal Reserve Chairman Paul Volcker, the Rule's namesake, has criticized the Proposed Rule for its length.[10] To some extent, the Proposed Rule's length is to be expected because the statute it implements, Section 619 of the Dodd-Frank Act, is itself replete with loopholes, exemptions and limitations. Even so, in issuing implementing regulations, the Agencies have avoided simple, bright-line rules that could have clearly delineated exactly what is and is not permissible under the statute. As discussed below, the Agencies have sadly eschewed clarity, instead muddying the regulatory waters with multi-factor tests, a vague intentionality requirement, newly created loopholes and exemptions, and definitional uncertainty. The absence of bright-line rules was not a happenstance or an unintended consequence; it was a conscious choice that evinces a lax regulatory posture among the Agencies. Federal Reserve Governor Daniel Tarullo recently testified before the Congressional Financial Services Committee that the Proposed Rule was designed to avoid "definitive bright lines" in favor of a "more nuanced framework."[11] We advise the Federal Reserve and the other Agencies not to confuse mere complexity for nuance. Simple bright-line rules make the compliance process easier, both for the regulated and for the regulator.

Another troubling element within the Proposed Rule is the Agencies' *ultra vires* interposition of an intentionality requirement into various aspects of the Proposed Rule, despite the complete absence of any explicit intentionality safe harbor in Section 619. Securities and Exchange Commission Chairman Mary Schapiro told the Financial Services Committee that "[w]e have no interest in pursuing activity where people are *intending* to provide market-making and get it wrong."[12] The banking lobby was undoubtedly heartened by this frank admission of regulatory forbearance. Even so, the Securities and Exchange Commission ("SEC") and the other Agencies are reminded that Section 619 requires strict compliance and imposes strict liability. ***Nowhere does the statute forgive "well-intentioned" breaches of the law.***

The Proposed Rule also evinces a remarkable solicitude for the interests of banking corporations over those of investors, consumers, taxpayers and other human beings. In their Overview of the Proposed Rule, "the Agencies request comment on the potential impacts the proposed approach may have on banking entities and the businesses in which they engage,"[13] but curiously fail to solicit comment on the potential impact on consumers, depositors, or taxpayers. The Administrative Procedure Act requires that, prior to the enactment of a substantive regulation, an

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[9] James B. Stewart. *Volcker Rule, Once Simple, Now Boggles*, N.Y. Times, Oct. 21, 2011. *available at* http://www.nytimes.com/2011/10/22/business/volcker-rule-grows-from-simple-to-complex.html?_r=1&pagewanted=all.

[10] *Id.* ("I'd love to see a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance.").

[11] Phil Mattingly & Cheyenne Hopkins. *Volcker Rule Regulators Resist Lawmakers Calls to Scrap Proposal*. Bloomberg BusinessWeek, Jan. 24, 2012, *available at* http://www.businessweek.com/news/2012-01-24/volcker-rule-regulators-resist-lawmakers-calls-to-scrap-proposal.html.

[12] *Id.* (emphasis added).

[13] NPR at 66,849.

agency must give "interested persons" an opportunity to comment.[14] The Agencies seem to have lost sight of the fact that "interested persons" could include human beings, and not just banking corporations.

We are not flippantly criticizing the Agencies for having a lax regulatory posture in their implementation of Section 619. We are basing our concerns on the regulators' own words, as noted above, and as discussed in detail below.

B. The Absence of Penalties in the Proposed Rule

The Agencies have inherent authority to impose automatic penalties and fines for certain proscribed activities, and Section 619 does not impinge on that authority:

> Nothing in this paragraph shall be construed to limit the inherent authority of any Federal agency or State regulatory authority to further restrict any investments or activities under otherwise applicable provisions of law.[15]

Nevertheless, the Proposed Rule fails to define any automatic penalties or fines for violations of the restriction on proprietary trading. We are cognizant of the fact that Section 8 of the Bank Holding Company Act already contains a general framework for criminal and civil penalties. Nevertheless, the Agencies have the ability to define particular penalties for specific violations of the Volcker Rule, and they should consider doing so while drafting the Final Rule.

C. The Need for a Strong Volcker Rule

The passage of the Gramm-Leach-Bliley Act and other deregulatory actions taken by Congress and the financial regulators in the last 15 years have frozen up capital and stultified the economy, especially from the perspective of the average American.

Free from the enforced separation between commercial and investment banking, as originally required by the Glass-Steagall Act, banks now prefer to engage in self-interested proprietary trading rather than pursuing traditional banking activities that actually promote true "liquidity" across markets. Liquidity in opaque financial instruments may have increased in recent years, but real liquidity, which benefits consumers, investors, small business owners, and homeowners, has not followed suit. The inflation-adjusted Dow Jones Industrial Average is around the same level that it was in the mid-to-late 1990's.[16] Similarly, the income of the typical American family is at the same level that it was in 1996.[17] However, unlike in 1996, over 28% of American homes are "underwater."[18] The banking lobby's elixir, financial market liquidity, has done little to

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[14] 5 U.S.C. § 553(c) (2011).
[15] 12 U.S.C. § 1851(e).
[16] E.S. Browning, *Adjusted for Inflation, Dow's Gains Are Puny*, Wall St. J., Dec. 28, 2009.
[17] Conor Dougherty, *Income Slides to 1996 Levels*, Wall St. J., Sep. 14, 2011.
[18] John Gittelsohn, *U.S. 'Underwater' Homeowners Increase to 28 Percent, Zillow Says*, Bloomberg, May 9, 2011, *available at* http://www.bloomberg.com/news/2011-05-09/u-s-underwater-homeowners-increase-to-28-percent-zillow-says.html.

reverse this trend. We therefore urge the Agencies to take banks' animadversions regarding "liquidity" with a grain of salt.

Certain commentators have opined that the Volcker Rule puts American banks at a global disadvantage. However, stable, customer-focused banks actually enjoy a competitive advantage as they are freed from the shackles of risk attendant to proprietary trading activities. This competitive advantage will create a first-mover advantage for American banks that pursue less risky, more productive activities. Foreign banks that continue to conduct proprietary trading will fail at higher rates, thereby undermining their competitiveness.

Much of the criticism levied upon the Agencies by Canadian, Japanese, and European banks and regulators has been unwarranted. As the Agencies are aware, the Volcker Rule does not prohibit proprietary trading activities outright. Rather, the Rule only restricts banks that have an implicit government insurance policy from engaging in such activities. The "invisible hand of the free market," that darling cherub of neoliberal economics, will likely push much of the current proprietary trading into the folds of hedge funds or traditional investment banks, not eliminate them outright (assuming, of course, that such activities actually add productive value to the economy). The Volcker Rule simply removes the government's all-too-visible hand from underneath the pampered haunches of banking conglomerates.

II. DEFINITIONAL ISSUES

A. Covered Financial Position

1. Definition of Loans

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.[19] The current definition implies that securities, derivatives, and commodity futures are not considered loans. However, this distinction should be made explicit, clarifying that any "loan" with the properties of a commodity[20] 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,*[21]
> 2. *in which there is common trading for speculation or investment,*[22]
> 3. *that materially has the characteristics of a commodity, security, or derivative, or*
> 4. *that falls within the scope of § _.3(b)(3)(i)*

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 Special Purpose Vehicle ("SPV").[23] 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.[24] In

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[19] Proposed Rule § _.3(b)(3)(ii)(A).

[20] As discussed below, commodities should be included as covered financial positions.

[21] This language derives from *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293 (1946).

[22] This language derives from *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990).

[23] 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).

[24] *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

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."

2. The Exclusion of Commodities

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.[25]

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 that 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**."[26] 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 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."[27] 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

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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).

[25] 12 U.S.C. § 1851(h)(4).

[26] 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Levin) (emphases added).

[27] Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890, 1892 (proposed Jan. 11, 2011).

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.[28]

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.

B. Scope of Entities Included in Covered Fund Definition

1. Statute's Intent

The Volcker statute states that the Agencies have the authority to expand the scope of "covered fund." Section 13(h)(2) of the Bank Holding Company Act ("BHC Act") states that 3(c)(1) and 3(c)(7) funds "or such similar funds as the appropriate Federal banking agencies . . . may . . . determine" all fall under the definition of covered fund. In fact, the Financial Stability Oversight Council ("FSOC") has specifically recommended that the Agencies utilize this authority to broaden the scope of covered fund beyond a definition tied to 3(c)(1) and 3(c)(7):

> [T]he Council recommends that Agencies consider using their authority to expand the definition by rule to funds that do not rely on the section 3(c)(1) and 3(c)(7) exclusions, but that engage in the activities or have the characteristics of a traditional private equity fund or hedge fund.[29]

We encourage the Agencies to adopt a qualitative definition of "covered fund." This interpretation would facilitate the effective policing of any fund that engages in proprietary trading activity. Given the ingenuity banks and their lawyers have shown in the past in evading quantitative criteria for regulation, we recommend that the Agencies include a catch-all qualitative category of covered fund. This qualitative category would include any subsidiary entity that exhibits the characteristics of a fund that takes on proprietary trading activities. In brief, if a fund can devote any portion of its activities to proprietary trading activity, then the Agencies should be able to consider it a covered fund. Moreover, the definition should be additive, such that it defines a covered fund as a fund exempted by 3(c)(1) or 3(c)(7), **or** any other fund that engages in proprietary trading beyond a *de minimis* level. We have outlined these suggested modifications in *Annexure B*.

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[28] *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).

[29] Financial Stability Oversight Council, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds 62 (Jan. 18, 2011) (emphasis added), *available at* http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf [hereinafter FSOC Study].

2. Commodity Pools

Commodity Pools are hedge funds and should be treated as such. The CFTC has in the past regarded many commodity pools as hedge funds, and we applaud the Rule's inclusion of commodity pools as covered funds.

3. Broker-Dealers

We are concerned that covered funds can take the form of broker-dealers (exempted under section 3(c)(2) of the Investment Company Act) and maintain a majority of assets in government securities, avail of the Rule 3a-1 or Rule 3a-6 exemption, or avail of an explicit exemptive order, and in doing so carry out proprietary trading through that fund free of the Volcker Rule's limitations. According to Rule 3a-1 or Rule 3a-6 of the Rules and Regulations promulgated under the Investment Company Act, a prima facie exclusion is created from the Investment Company Act if 55% or more of a fund's value is stored in government securities and other non-investment securities. In other words, a fund can avail of the 3a-1 exclusion despite devoting up to 45% of its assets to explicit proprietary trading.

Unless the 3a-1 exclusion is brought within the remit of the Volcker Rule, a banking entity could purchase a fund availing of this exclusion to conduct extensive proprietary trading (up to 45% of the fund) free of the Volcker Rule's prohibitions.

We recognize that a 3(c)(2) broker dealer is required to be "primarily engaged" in customer-focused activities.[30] However, the current interpretation of "primarily engaged" would create an enormous loophole for banking entities to skirt the covered fund restrictions. A fund can still avail of the 3(c)(2) exemption while devoting up to 45% of its assets to explicit proprietary trading.[31] Unless 3(c)(2) broker-dealer funds are brought within the purview of the Volcker Rule, a banking entity could purchase such a fund as a subsidiary, and conduct extensive proprietary trading (up to 45% of the fund) free of the Volcker Rule's prohibitions.

4. Foreign Banks

Foreign banks exempted under 3(a)(6) are required to be engaged "substantially" in commercial banking activity, but members of the securities bar have been comfortable opining that a 20% activity level is sufficient to qualify as "substantial."[32] Unless 3(a)(6) is brought within the scope of the Volcker Rule, a banking entity could conduct proprietary trading activities through the acquisition of a foreign bank subsidiary that is engaging 79.99% in investing, reinvesting, or trading in securities.

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[30] *See generally, U.S. v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 713-19 (1975).
[31] *See* Federated Capital Mgmt. Assoc., SEC No-Action Letter (Aug. 1, 1975).
[32] Seward & Kissel, SEC No-Action Letter (Oct. 15, 2005), *available at* http://www.sec.gov/divisions/investment/noaction/seward101205.htm (last visited Jan. 29, 2012).

C. Definition of Trading Account

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. The NPR's allowance is so wide as to allow unfettered trading of structured repos as well as vanilla repos. Further, the Supplementary Information's claim that repos are economically loans[33] does not justify the blanket allowance. By convention, a repurchase agreement is booked as a pair of standard purchase and sale transactions. Repurchase agreements are also not treated as loans for the purposes of bankruptcy, regardless of their economic substance.[34] Because repos are not **legally** loans, they would *not* be permitted through the language in Section 13(g)(2) of the BHC Act that allows for the sale of loans. There is no mention of repos in the statute or in the FSOC Study. In fact, there is not a scintilla of support in the Congressional Record for the blanket repo exemption.

The exclusion of repos from the definition of trading account poses a dangerous threat to the financial stability of the United States. Federal Reserve Chairman Ben Bernanke has underscored these risks in an interview with the Financial Crisis Inquiry Commission.[35]

We ask that the Agencies carefully consider the fact that **repos could be used in a variety of ways to evade the rules and serve as a conduit for proprietary trades**. As we will show in detail in *Annexure A*,[36] evasive proprietary trading can be achieved through repos in order to conduct: Shorting, Basis Trades, Put Options, Interest Rate trades, Credit Default Swaps, and Total Return Swaps, among others.

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

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

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[33] NPR at 68,862.

[34] *See* 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)).

[35] *See* 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.

[36] Please see our detailed answers to Questions 30-32 (*Annexure A*), which outline various 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.

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 section § _.6, with the following requirements to qualify for the allowance:

- 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

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.

III. PROPRIETARY TRADING

A. Underwriting

We suspect that the vast majority of comment letters on the proposed implementation of the Volcker Rule will criticize the Agencies for promulgating unduly complicated rules. The proposed implementation of the underwriting exemption is a prime example of the Agencies injecting needless complexity into a simple statutory mandate.

1. The Underwriting Exemption Should be Limited to Registered Securities

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.[37] 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."[38] Such a person is required to file a registration statement before offering to sell a security as part of a primary distribution.[39] 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."[40] 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.[41] Section 2(a)(11) has close to a century of case law and interpretive guidance

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[37] *Chevron U.S.A. Ins. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984).
[38] 15 U.S.C. § 80b-2(a)(11).
[39] 15 U.S.C. §§ 80b-4(1), 5(c).
[40] Preliminary Note to Rule 144. 17 C.F.R. § 230.144 (2012).
[41] *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 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.").

supporting it, and 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.[42] 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 over-the-counter ("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 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;

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

(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.

2. Retained or Unsold Allotments are Indicative of Proprietary Trading

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, 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,"[43] 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

[43] 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/.

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.

3. Equivocal Regulatory Language

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 threaten to 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 arrangements were 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.

4. Disgorgement as a Mechanism to Ensure Revenue Generation from Fees

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 out 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"*[44] *as a further vindication of an explicit disgorgement requirement.*

B. Market Making

Market making is an indispensable component of liquid, efficient markets. This service, however, simply does not belong in banks. One of the most challenging aspects of our attempt to digest and comment on this Proposed Rule has been navigating the presupposition that banks have some inherent role in proper market making. We are familiar with the extensive lobbying efforts by the banking industry to present this idea as a fact, but we propose that the Agencies seriously reconsider this premise for both the safety and soundness of the industry and the simplicity of this Rule. Nobel Prize winner Myron S. Scholes wrote:

> [A] leveraged market-making business is inherently unstable. Banks might be the wrong providers of liquidity to markets. Simply put, leverage can only be reduced by selling assets to raise cash if market makers are making markets in the assets they need to sell and they no longer can continue to do so at times of shock and to make conditions worse, they borrow from each other with short-term financing to hold longer-maturity relatively idiosyncratic assets.[45]

The bank lobbying effort is certainly understandable: market making is a profitable business and one that banking entities certainly do not want to lose. It is well-known that the major dealers have always fiercely guarded their dominance of market making, particularly in the less regulated OTC markets. Firms that attempt to enter this business are regularly strong-armed through anti-competitive arrangements with inter-broker dealers.[46] Again, this is unsurprising: market making desks allow a firm to take proprietary advantage of unparalleled access to valuable customer flow information in the name of "customer service."[47] This is an extremely attractive business. Despite the banks' desire to continue reaping such profits, their contention—that banking entities alone are able and willing to provide this valuable service to the market, and

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[44] *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/.

[45] Myron S. Scholes, *Market-Based Mechanisms to Reduce Systemic Risk*, *in The Road Ahead for the Fed* 103, 108 (John D. Ciorciari & John B. Taylor eds., 2009).

[46] *See Intervest v. Bloomberg*, 340 F.3d 144, 2003 U.S. App. LEXIS 16423, at *26 (3d. Cir. 2003) ("According to his ACT Notes, Fondren met again with Matthews and Tom Evans, another Cowen executive, on May 29, 1997. Fondren recorded that Evans initiated the meeting to inquire whether InterVest might assist Cowen in developing its own bond trading exchange over the internet. Matthews, however, seemed less interested in dealing with InterVest and told Fondren that doing business with InterVest was 'viewed by the street as "unhealthy."' When Fondren responded by charging that locking InterVest out of the bond market was anti-competitive and could lead to a lawsuit, Matthews allegedly laughed and said that even if Cowen was forced to pay $10 or $20 million, 'it would be just a cost of doing business.'").

[47] 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.").

that regulation will cause irreparable damage to the financial system at large—is unfounded and nonsensical.

It is our opinion that this Rule would be universally improved by removing the blanket exemption for market making, as it presents great financial risk (by providing substantial opportunity for evasion) without commensurate economic benefit. We understand, however, that we are bound by the statute and this unfortunate loophole must be tolerated. Our goal then, in crafting this public comment, is to highlight those areas where the implementation of this legislation will be least consistent with its intent, and provide suggestions and guidance that attempt to improve the Final Rule's substance and effectiveness.

1. Illiquid and OTC Markets

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.

It should require little reminder that risky and illiquid products—including certain bonds, credit default swaps ("CDS") and other complex derivatives—were crucial contributors to the 2008 financial crisis. For this reason, the original legislation sought to expel these functions from federally-backstopped banking entities. We find it disingenuous to suggest that this was not commonly understood by banking entities, regulators, and the public long before this Proposed Rule was drafted. Senator Merkley explicitly addressed the prohibition of market making in credit default swaps and other "high risk instruments"[48] in his remarks to Congress:

> 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 not a firm provides market liquidity: high-risk assets and high-risk trading strategies are never permitted.[49]

We are troubled by the way this very clear explanation has been ignored throughout the Proposed Rule; exemptions including CDS and other, riskier products are plainly unwarranted and, in our opinion, extremely dangerous.

Additionally, it 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:

> Testimony by Goldman Sachs Chairman Lloyd Blankfein and other Goldman executives during a hearing before the Permanent Subcommittee on Investigations

[48] *Id.* at S5898 ("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.").
[49] *Id.*

> 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.[50]

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."[51] This speaks both to bespoke structured products, for 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.[52]

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 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,

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[50] *Id.* at S5896.
[51] *Id.*
[52] NPR at 68,871 (emphasis added).

or enforce this Rule in any meaningful way with respect to these products, which provide myriad opportunities for large proprietary positions to be justified, disguised, or overlooked.

We propose the inclusion of the following language into § _.4(b)(1):

> (1) Permitted market making–related activities. The prohibition on proprietary trading contained in § _.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with the covered banking entity's market making–related activities, *provided such activities do not include or incorporate:*
>
> *(i) Assets whose changes in values cannot be adequately mitigated by effective hedging;*
> *(ii) New products with rapid growth, including those that do not have a market history;*
> *(iii) Assets or strategies that include significant embedded leverage;*
> *(iv) Assets or strategies that have demonstrated significant historical volatility;*
> *(v) Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and*
> *(vi) Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;*

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.

a. 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.[53]

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*"[54] is functionally identical to "all revenues," to the degree that they can be meaningfully differentiated.[55]

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[53] 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley).
[54] NPR at 68,872 (discussion of the fifth market-making criterion, § _.4(b)(2)(v)).
[55] The inclusion of the word "primarily" serves to further erode this requirement.

The attempt to reconcile these two conflicting ideas is a primary source of complexity throughout this Proposed Rule, and this conflict serves to diminish the Rule's effectiveness in practice. The FSOC Study indeed highlighted this issue[56] in its recommendations, and yet it remains as a cornerstone of the Rule's structure.

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. Three of these trades were conducted with clients, and 7 through an inter-dealer broker. Other 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? 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 could be one of many traded by a market maker. It might in fact be used to offset one or many other positions or even products. It may, as is often the case, be 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.

Clearly there are few reasonable solutions to the regulatory problems posed by bid/offer spreads within illiquid markets. As noted above, 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.[57] This would eliminate the problem of differentiation of revenues, in addition to significantly reducing the incentive to take prohibited proprietary exposures.

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[56] FSOC Study, *supra* note 29, at 24 ("[M]easuring the revenue that is attributable to the bid-ask spread is difficult and not consistently observable especially in illiquid markets.").

[57] 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.

b. 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,[58] are mitigated through proxy hedges[59] that are imperfect (indeed sometimes completely unrelated), but available and economical.[60] In other cases, such risks are seen as uneconomical to hedge at all.[61] This issue is addressed in greater detail below.

c. Warehousing Illiquid Risk

In explanation of the statutory prohibition of high-risk assets and strategies,[62] 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.[63]

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[58] *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.").

[59] 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 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.").

[60] *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.*

[61] FSOC Study, *supra* note 29, at 20 ("In general. it may be uneconomical to completely hedge all of the risk to which a trading desk is exposed.").

[62] 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))").

[63] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

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 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."[64]

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. If legitimate market making activities require, or otherwise cause, a banking entity to assume large illiquid positions (as the industry claims it must),[65] 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.

d. 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. Regardless, this supposition assumes that reasonably accurate and meaningful data can be collected. But this is often not the case: 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.[66]

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[64] FSOC Study, *supra* note 29, at 19.

[65] *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].

[66] 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).

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. Any banking entities or sub-entities hoping to make use of this exemption should be required to demonstrate that they meticulously ensure that this requirement is consistently and obviously met. Here, 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)

e. Near-term Demands

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 submitted an alternative Market Making Commentary at *Annexure C*, wherein we have removed the language of this requirement.

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 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.

2. Illiquid and OTC Markets

It is clear that much of this Proposed Rule has been based on the assumption that the relevant activity will occur within highly liquid and exchange-traded equity markets. Although this is an excellent simplifying factor, it is tremendously unrealistic. The Commentary in Appendix B delineates how this assumption 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 the Volcker Rule. **Illiquid markets were and continue to be havens of risky and irresponsible activity, yet they are largely forgiven throughout this Rule.**

We have submitted an alternative Market Making Commentary, attached as an *Annexure C* to this comment letter. Our major concern in providing alternative language was to address the excessive flexibility in the current Commentary's interpretation of illiquid products. We have emphasized throughout this comment letter that the potential for proprietary trading in illiquid markets is massive. An unfortunate consequence of the generalized language in this

Commentary and throughout the Proposed Rule may be the shift of risky practices out of liquid and transparent markets into the less regulated illiquid and OTC products. We have provided alternative language with more stringent requirements for illiquid and complex products, such that they are held to the standards outlined in this Rule more closely.

We outline below the specific issues that we attempted to address in our alternative Commentary.

a. Removal of Bid/Ask spreads as Legitimate Trading Revenue

Revenue generated by capturing bid/ask spreads is functionally identical to gains from price movements in the underlying securities. We reject the notion that this is either indicative of bona fide market making or practically feasible to implement, and have removed this from the list of indicia.

b. Revenue per Unit of Risk Taken, Consistent Profitability, and Earnings Volatility

This is an extremely important and necessary factor that will provide invaluable information about the nature of the trading activity. We have seen a tremendous amount of concern by banking entities and their lobbyists regarding this particular point.[67] Their concern serves to illustrate the strength of these factors in identifying prohibited activity. We would like to emphasize that trading books with sufficiently low risk and consistent customer-servicing activity will be able to adequately demonstrate the qualities listed above.

c. Reasonably Expected Near-term Customer Demands

We reject the notion that an estimation of the "near-term demands of clients" is a meaningful consideration in illiquid markets. The question of "if" there will be demand (near-term or otherwise) is of much greater importance than the degree of such demand, should it exist at all. Regardless of whether such demand is resulting from or in anticipation of client activity, the Rule serves to allow banking entities to warehouse significant illiquid risk for extended periods of time *because* that is just how illiquid markets work. We see this as a grievous logical error that should be stricken from the Commentary and seriously reconsidered by the Agencies in general. This issue will be discussed in greater detail below.

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[67] *See, e.g.*, SIFMA & Oliver Wyman, *supra* note 65, at 10 ("Many elements of the compliance regime in the Proposed Rule seem to be based on an assumption that market making functions should show consistent revenue, risk taking, and trading patterns, both over short time periods (day to day) and across different periods of market conditions. In both more and less liquid markets, customer flows are often 'lumpy' (e.g., via facilitating block trades), and volatile risk-taking and revenue are natural consequences for market makers. In addition, market conditions–and the way market makers both serve customer needs and manage their own risks–can shift substantially over time.").

3. Anticipation of Near-Term Client Demands

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.[68] 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," or, 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,[69] but the Rule fails to address this concern by requiring that the other sources of such information be demonstrable and verifiable by regulators.

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 in less liquid or standardized markets. 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.[70]

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

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[68] For instance, such information can include Level 2 market data or NASDAQ's Depth of Book data.

[69] 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.").

[70] 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.

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.*[71]

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,"[72] 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,[73] and we urge the Agencies to reconsider the appropriateness of this requirement in light of the coinciding statutory prohibition of such a conflict.[74] Anticipatory accumulation of inventory should be removed from the description of market making, and considered to be prohibited proprietary behavior.

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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[71] NPR at 68,871 (emphasis added).

[72] *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.")

[73] FSOC Study, *supra* note 29, 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.").

[74] 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. Riskless Principal Transactions

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.

5. Client, Customer, Counterparty

The need to identify and quantify which trades are in fact customer servicing and "customer-initiated"[75] 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 the 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.

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[75] FSOC Study, *supra* note 29, at 3.

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

Finally, the FSOC specifically calls for the Proposed Rule to explicitly define the characteristics of a client, and these factors (direct vs. indirect relationships, nature of initiation) should be considered central to such a definition. We propose the following definition of "customer, client, or counterparty" to be used through out 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 effective implementation of the Rule that the term "customer" be well-defined.

6. Compensation Incentives

Thoughtful and responsible compensation regimes will undoubtedly be one of the most important tools for effecting immediate and substantive improvements to the banking industry, and it follows that 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 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 skillset required in a successful risk-taker differs from that required in 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[76] by adding the word "primarily,"[77] 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 negligible VaRs at year-end. 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 equivalent to 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). 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[78] 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 language of the Commentary in Appendix B, which we have submitted as *Annexure C* to this letter.

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[76] 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.").

[77] 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).

[78] *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.").

7. Numerical Thresholds

In general, we believe that numerical thresholds will be useful to the Agencies in guiding their own operational techniques for monitoring compliance. We encourage the Agencies to develop such thresholds and keep detailed records on the frequency and degree to which they are exceeded. A regular pattern of excessive breaching of such limits should be treated with penalties and increased scrutiny of all trading activities.

We would caution, however, against incorporating such thresholds directly into the language of the Rule for several reasons.

First, we see explicit targets and numerical boundaries as easily abused and evaded by banking entities. In light of the many creative structures that banks use to evade accounting and tax rules,[79] our collective experience overwhelmingly confirms that risk managers at banking entities are indeed uniquely capable of massaging data such that it avoids triggering increased oversight. In light of the extensive explanation of prohibited vs. permitted activity throughout the balance of the Proposed Rule, it is clear that banking entities have sufficient guidelines to determine the permissibility of future activities. The thresholds used by the Agencies to prompt additional investigation should be known by the Agencies alone.

Furthermore, due to the constantly evolving nature of financial markets, having hard-coded numerical thresholds in the Final Rule would provide extensive complication in the future as these thresholds would need to be constantly revised and updated. We see significant risk and limited advantage to including hard numerical values within the Rule.

8. Compliance Requirements

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

[79] Joseph Cotterill, *Repo 105: the Fun Starts all Over Again*, FT Alphaville, Mar. 29, 2011, http://ftalphaville.ft.com/blog/2010/03/29/190356/repo-105-the-fun-starts-all-over-again/.

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.[80] 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.

C. Risk-Mitigating Hedging

Our general interpretation of the Risk-Mitigating Hedging exemption is that all proprietary trades can be effectively designated as the hedge of some specific risk to evade prohibition. In an attempt to account for the substantial differences among traded instruments, the Rule has broadened the scope of permissible hedging activity to ubiquity. We will address our specific concerns with respect to the Risk-mitigating Hedging exemption below.

1. Hedged Risks

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.

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[80] 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).

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.[81]

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.

2. Hedge Correlation and Appropriateness

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 the hedges that are consistently appropriate for each product.* This will eliminate confusion 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.[82]

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-

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[81] NPR at 68,876 (discussion of § _.5(b)(2)(iv)).
[82] *Id.* (discussion of § _.5(b)(2)(iii)).

sense oversight.[83] 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."

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 products. With enough sponsorship, such a proxy hedge can abandon its own fundamentals and adopt the technical qualities of the 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. This kind of forward-looking oversight encourages responsibility and combats attempted evasion.

3. Hedging Documentation Requirement

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. Additional documentation should be required of all trades that intend to rely on the risk-mitigating hedging exemption. The process for confirmation and substantiation of trades utilizing this exemption should be streamlined and accessible for regulators to monitor.

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

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[83] *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.").

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 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.

4. Portfolio Hedging

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.[84] 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

[84] 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.

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, to the extent that such groups are not already in place.

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. 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),[85] 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.

5. Anticipatory Hedging

We have several technical concerns arising from the allowance for anticipatory hedging within the Supplementary Information. First, we are alarmed by the potential similarities between anticipatory hedging, as described in the Supplementary Information, and a common understanding of illegal front running. We see a potential for confusion or conflict with respect to such a differentiation. Furthermore, this issue is not addressed in the Statute, the Congressional Record, the FSOC Study, or the Rule itself. Its inclusion within the Supplementary Information is potentially problematic and unsubstantiated by any relevant input,

[85] 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.").

and so we propose that this language be completely removed from the Supplementary Information.

6. Suggestions

In summary, we recommend the following suggestions with respect to the risk-mitigating hedging exemption:

- Require that all risks be hedged. If the responsible mitigation of a risk is considered "uneconomical," it should be considered a prohibited proprietary exposure.
- Require that each type of exposure be designated as one that is hedged exclusively on either an Individual or an Aggregate basis.
- 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 to be appropriate for a given product, to promote consistency across banking entities.
- Remove any explicit or implicit allowance for anticipatory hedging.

D. Permitted Trading Outside of the United States

1. Criteria for Permitted Trading Outside the United States

The foreign trading exemption outlined in § _.6(d) is 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, and further guarantee that holdings of U.S. banking entities that are **already** offshore are not allowed to skirt the Volcker Rule. Section _.6(d)(1)(iii) is critical because without it, 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.

The remaining definitions in this exemption—the definition of when "purchase or sale occurs solely outside of the United States," as well as the definition of "resident of the United States"—are sufficiently clear, effective, and necessary to be retained in the Final Rule in order to avoid rule evasion by subversion of this foreign trading exemption.

E. Appendix A - Quantitative Measurements

We see the uses of reported quantitative measurements as generally comprising three main goals, each of which will be addressed by the data with varying degrees of effectiveness.

i. 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.

ii. 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.

iii 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.

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. The specified measurements are effective because they are the most indicative standard market metrics available today. 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. 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.

1. Definitions

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[86] of the Supplementary Information. Footnote 191 defines the trading unit with sufficient granularity. We are pleased that the NPR has moved to require measurements at multiple levels of organization, which will serve to combat evasion concerns.

With respect to technical matters, we find the reporting frequency is extremely effective and should not be reduced in any way. Additionally, the recordkeeping requirement should be extended to 6 years, such that it matches the NY State Statute of Limitations for Contracts.

2. Enhanced Reporting Threshold

In general, we are satisfied with the $5 billion threshold for enhanced reporting requirements, as it a sufficiently small number that the vast majority of problematic operations should fall safely above it. However, with respect to derivatives valuations, we are concerned that large exposures may be poorly accounted for in such regimes. For instance, in the criteria set by Call Report's Schedule RC-D,[87] credit default swaps and other derivatives may be valued substantially lower than their notional exposure. For example, a $100 million credit default swap could have a "fair value" of close to zero on the day of inception. This is the standard risk-weighted evaluation, but the public's collective experience with AIG in recent years demonstrates the significant dangers of large unmonitored derivative positions. 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.

We propose that all banking entities that engage in any trading operations (regardless of threshold) be required to provide the limited reporting requirements specified in § _.7(a), in addition to:

i. <u>VaR Exceedance</u>

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

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[86] NPR at 68,885 n.191 ("As noted in Appendix A, the Agencies expect that this would generally be the smallest unit of organization used by the banking entity to structure and control its risk-taking activities and employees, and would include each unit generally understood to be a single 'trading desk.' For example, if a banking entity has one set of employees engaged in market making-related activities in the equities of U.S. non-financial corporations, and another set of employees engaged in market making-related activities in the equities of U.S. financial corporations, the two sets of employees would appear to be part of a single trading unit if both sets of employees structure and control their trading activities together, making and executing highly coordinated decisions about required risk levels, inventory levels, sources of revenue growth and similar features. On the other hand, if the risk decisions and revenue strategies are considered and executed separately by the two sets of employees, with only loose coordination, they would appear to be two distinct trading units. In determining whether a set of employees constitute a single trading unit, important factors would likely include whether compensation is strongly linked to the group's performance, whether risk levels and trading limits are managed and set jointly or separately, and whether trades are booked together or separately.").

[87] 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.

ii. Risk Factor Sensitivities

All banking entities that maintain risky portfolios will be already 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.

iii. 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.

3. Thoughts on Current Measurements

The proposed quantitative measurements are generally appropriate for certain liquid and transparent trading activities. We have some specific concerns with methodology, and we would like to reiterate that many of the measurements are not meaningful in illiquid markets or for derivatives instruments.

VaR, Stress VaR, and VaR Exceedance

VaR gives a 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. 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 Exceedance may be useful to the regulators as an indicator of the quality of the VaR measure relative to the profit and loss of the 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.

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:

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).

Variability of the VaR model result against a standard benchmark portfolio should be reported to the regulators. We recommend that the Office of Financial Research ("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.

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 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.

Risk Factor Sensitivities Risk and Position Limits

Risk Factor Sensitivities will be the most useful tool for identifying the accumulation of market risk in different areas of a banking entity. We are concerned with the examples in the Supplementary Information, and 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.

Additionally, as 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 Agencies. The Portfolio PnL associated with such sensitivities should always be reported in conjunction with each snapshot.

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 demonstrable and commonly understood metrics,[88] and therefore such metrics hold the greatest risk of manipulation by individuals within the banking entity.

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[88] *See* NPR at 68,957 (Appendix A) ("*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.").

Additionally, we propose a slight change to the Calculation Guidance for Comprehensive Profit and Loss, which seems to include a small but serious error. "Spreads" is a largely meaningless word with respect to PnL calculations, and should be removed from the list of components of Comprehensive PnL. We would like to note that the description of Comprehensive PnL 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.

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. Outside of the most liquid and transparent markets, the Calculation Guidance for this measure is largely nonsensical, as the guidance for bid/offer spreads illiquid markets amounts to "just make it up." 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, 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. However, the mention of "customer spreads, bid-ask spreads"

is extremely unclear in the Guidance. "Customer spreads" is not 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 PnL (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.

Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss
This is a useless measure as currently defined, because the calculation periods are inappropriately short to yield meaningful data. 30 days or even 90 days is insufficient for estimating these statistics, which can be demonstrated by any computational package thus: Take a Student's t-distribution with say 3 degrees of freedom, take a sample size of 30 or 60 or 90, and compute the sample skewness and kurtosis. Do this 10,000 times for each window length and view the histogram of the resulting estimates. It will be observed that there is not a tight band around the "true" value. We strongly suggest using 2 years of daily data as an appropriate calculation period for these measures.

Inventory Aging, and Inventory Turnover
This is a useful metric only with respect to certain cash securities. With derivative securities, Inventory is not a very 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.

4. Additional Metrics

We propose that the Agencies consider including several additional quantitative measurements that would fill important holes in the current reporting regime.

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.

5. Illiquid Assets and Model-Based Valuations

The quantitative measurements do not provide useful information as applied to all asset classes. Less reliance should be placed on the quantitative measures for those asset classes that trade in relatively illiquid markets since the data on which the calculations are based may be unobservable, model driven or stale. Absent a metric to measure the quality of the underlying data, these measures should be subject to greater scrutiny, and the impact of these data should be clearly disclosed.

For trading strategies that rely heavily on models to calculate risk exposures (e.g., correlation trading portfolios, etc.), additional disclosures in the Risk Factor sensitivities should be required to evaluate the reliability of the model-driven reporting.

Similarly, additional disclosure in the Risk Factor Sensitivity reporting should be required to evaluate the quality of the metrics for portfolios that have exposure to Assets having value that is model-derived. This requirement can be linked to the Level 1, 2 or 3 classifications used by the firm to report its positions in its financial statements. For example, if total Risk Factor sensitivities contain exposure from Level 3 (model-derived valuation) assets, an additional disclosure identifying the Risk Factor Sensitivity to those assets should be required.

6. Burdens

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.

The relevant infrastructure is already in place, and minimal additional resources should be required to implement the reporting of quantitative measures in this Rule. The general Calculation Guidance is consistent with current industry practice for managing risk, preparing profit and loss attribution, and preparing financial reports. 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.

Following the financial crisis of 2008, it was our collective experience as industry professionals that many banking entities realized that their fragmented risk management systems were a substantial problem that needed to be addressed. In the years following the crisis, substantial efforts were made at banks, both domestic and foreign, to consolidate risk models, build the appropriate software infrastructure, and facilitate oversight by senior management and the risk departments. Efforts like these were undertaken at many banks and these efforts should flow easily into the metrics that the Agencies are requesting for reporting in this Rule. Any claim that such an implementation would be too costly to perform ignores the fact that similar initiatives were launched, planned, and executed in the wake of the 2008 crisis. We acknowledge that even given such efforts, there will still need to be tweaks and adjustments made to account for the reporting demanded by the Volcker Rule. They should not, however, be so substantial as to be burdensome. Indeed, the need for new, independent efforts to build firm-wide risk systems to comply with this Rule should be seen as an indication of serious shortcomings in current risk regimes. Implementing these reporting requirements will only promote the safety and soundness of the banking industry at large.

F. Burdens and Benefits of the Volcker Rule on Trading Activities

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.

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: "This bill is an insurance policy against an expensive future taxpayer bailout."[89]

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

[89] 156 Cong. Rec. S5893 (daily ed. July 15, 2010) (statement of Sen. Conrad).

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.

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.

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. 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.

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.[90] 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.

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[90] 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.").

Additionally, it is our hope that the Proposed Rule's increased compliance and reporting requirements 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. Certainly, many jobs will be created as banking entities grow Compliance, Risk Management, and other operational divisions. Regardless of the amount of paperwork it may necessitate, we see this increased diligence as a benefit, not a burden.

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 all of its shortcomings, will do more to promote the safety and soundness of the covered banking entities and banking system at large than any other piece of legislation since Glass Steagall. This is surely the greatest benefit of all.

IV. COVERED FUNDS

In their allowances for the continued provision of Asset Management and Investment Advisory services to covered funds by banking entities, Congress granted a boon to the financial industry at the expense of the American public.

While the intent of the statute's allowances for Asset Management may have been justifiable, in reality these anticipated allowances are being used by the banking entities to simply shift proprietary trading from inside their walls to outside, with a healthy amount of ownership interests maintained to keep their involvement profitable.

CNBC reported back in March of 2011—in the appropriately titled article *Prop Trading Moves Down the Hall at JPMorgan*—that "JPMorgan is moving its proprietary trading unit out of its investment banking division and into its asset management division" and that it expected to seed the group with $2 billion of capital.[91] A September 2011 issue of *Invest Hedge* magazine confirms the earlier story in a profile on J.P. Morgan's Alternative Asset Management division that states that the bank's proprietary trading "is migrating from investment banking to asset management to comply with the Volcker rule."[92]

As we shall discuss below, the exemption for asset management and the abundant allowances for investments in covered funds not counted towards the 3% ownership limit (i.e., personal investments, broadly permitted risk-mitigating hedging and carried interest), all combine to pose a threat to the financial stability of the United States.

A. Definitions

1. Covered Fund

While we support the current definition of "covered fund" as defined in §§ _.10(b)(1)(i)-(iv) of the NPR, we feel that in *addition* to this definition, there could be a second, additive definition that allows the Agencies to include *other* funds not covered by § _.10(b)(1)(i) in the definition of covered fund.

Specifically, we suggest that the definition of "covered fund" be extended such that issuers identified in §§ _.10(b)(1)(i)-(iv) as well as *any* of the following issuers would qualify for the definition of a "covered fund":

> *§ _.10(b)(1)(v): An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for Section*

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[91] Ash Bennington, *Prop Trading Moves Down the Hall at JPMorgan*, CNBC: NetNet, Mar. 1, 2011, http://www.cnbc.com/id/41847719/Prop_Trading_Moves_Down_the_Hall_at_JPMorgan.

[92] Clair Makin, *Customization Takes Root at JP Morgan*, Invest Hedge, Sep. 2011, at 56, *available at* http://www.jpmorganinstitutional.com/cm/BlobServer/Invest_hedge_0911_article.pdf?blobkey=id&blobwhere=1321475157438&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

3(c)(2) of that Act, or Rule 3a-1 or Rule 3a-6 of the Rules and Regulations promulgated under that Act, and

§ _.10(b)(1)(vi): Any issuer that the [Agency] deems to be a covered fund, should the Agencies deem that said issuer exhibit the characteristics of a fund that takes on proprietary trading activities;

2. Carried Interest

We believe that carried interest should be included as an ownership interest. Carried interest is **not** mentioned in or provided for by the Volcker statute. The exemption of carried interest from the definition of ownership interest seems to have been added as a result of lobbying by the financial industry, and contradicts statutory intent. Carried interest is similar to a fee that tracks gains on price movements, which Volcker prohibits. Investment advisers should earn money through flat fees for customer service, rather than relying on what is essentially an option on the covered fund. Since "option" is included as one of the instruments in an "ownership interest," carried interest should also be included in that list.

Carried interest is also inappropriate because, facing no downside exposure, investment advisers are incented to take extremely risky bets that could debilitate a fund and require a bailout by the bank. There is a further conflict-ridden incentive for the banking employee investment advisor to encourage the banking entity to acquire as large an ownership interest as possible through a risk-mitigating compensation "hedge." The more assets under management ("AUM") the fund has, the larger the potential carried interest for the investment advisor employee.

Finally, the treatment of carried interest in the NPR is inconsistent with its tax treatment. One of the major arguments in favor of taxing carried interest at a capital gains rate, as is the current practice, is that carried interest **is** an ownership interest, but under the NPR it **not**. **Carried interest should not provide loopholes to banking entities and to covered funds in both the realm of taxation and the realm of regulation.** Thus, for this and all of the reasons we have outlined above, we strongly suggest that the Agencies **include carried interest in the definition of ownership interest**, as we suggest in *Annexure B.*

B. Employee Ownership Interests in Covered Funds

We suggest that the Agencies **attribute to the banking entity any personal investments by a banking entity employee acting as investment advisor, regardless of the source of funds**. Failure to attribute personal ownership interest by an investment advisor working for the banking entity leaves room for improper incentives to bail out the covered fund should it reach dire straits. The Proposed Rule makes no limitations on self-funded, personal ownership interests held by banking entity employees working as investment advisers. For example, an investment adviser may be a majority or significant owner in the covered fund that she were advising. This advisor may be tempted to use her influence at the banking entity to provide assistance to the covered fund should it begin to falter.

In addition, § _.11(g) allows banking entity employees who provide "investment advisory or other services to the covered fund" to make personal investments in that fund. We ask that the Agencies **remove "or other services" from § _.11(g)**. The alleged purpose of the employee investment is to ensure that investment advisors have "skin in the game." The statute mentions no services other than investment advisory services, so the Proposed Rule is without authority in granting an exemption for "other services." In any case, non-advisor banking entity employees have no need to maintain "skin in the game," and this vague allowance could lead to directors or other high-ranking employees who may wish to earn profit on the fund's performance to provide a minimum service of any kind, and then freely invest in the fund. This has great potential to pollute the intent of Subpart C's restrictions.

C. Congressional Intent Behind the Seeding Period, Section 619(d)(4)(i)

The allowances of the one-year seeding period provided by the NPR are susceptible to evasion of the restrictions and are substantially at odds with Congressional Intent.

The terms of § _.12(a)(1)(i) that allow the banking entity to provide "sufficient initial equity" provide no guidance as to what a "sufficient" investment means. Thus, banking entities may invest up to a maximum 3% of their Tier 1 capital during the seeding stage (assuming no other covered fund investments are present). This is no small sum for the nation's largest banking entities: in Q3 2011, 3% of J.P. Morgan's Tier 1 Capital measured **$3.6 billion**.[93]

Looking to the Congressional Record, Sen. Merkley gave specific guidance as to how the seeding period should work:

> As a general rule, firms taking advantage of this provision should maintain only small seed funds, likely to be **$5 to $10 million or less**. **Large funds** or funds that are not effectively marketed to investors **would be evasions of the restrictions of this section**.[94]

Failing to give specific guidance as to the scope and limits of the investments made during the seed period leaves enormous potential for exploitation and abuse of the intent of the Rule. Given the potential for an extension of this seed period for up to two years, a banking entity could be the sole owner of a covered fund, in the amount of $3 billion or more, for up to a total of three years, and still be well within the limits of the Rule. It is clear that the financial industry is already operating under the assumption that it will be given free reign in this seed year, with Goldman Sachs and Deutsche Bank getting in early in the seed investment "frenzy."[95]

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[93] News Release. JPMorgan Chase & Co.. JPMorgan Chase Reports Third-Quarter 2011 Net Income of $4.3 Billion, or $1.02 Per Share, on Revenue f $24.4 Billion, Bank-Owned Life Insurance (Oct. 13, 2011), *available at* http://files.shareholder.com/downloads/ONE/1608042267x0x508390/2ae4e2c9-f6ba-4ed8-be22-0fdf55c1f5c1/3Q11_JPM_EPR_FINAL.pdf.

[94] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (emphases added).

[95] Azam Ahmed, *A Boom in Starter Capital for Hedge Funds*, N.Y. Times Dealbook, Jan. 9, 2012, http://dealbook.nytimes.com/2012/01/09/a-boom-in-starter-capital-for-hedge-funds/.

We strongly suggest that the Agencies follow Congressional intent and require that **during the seed period, a banking entity's ownership interest must be capped at $10 million, or the 3% Tier 1 capital limit, whichever is less**.

D. Other Permitted Investments in Covered Funds

1. Permitted Risk-Mitigating Hedging

We suggest that the Agencies **remove the permitted "hedging" of compensation arrangements** through an ownership interest in a covered fund provided by § _.13(b)(1)(i)(B), as it conflicts with the language of the statute.

However, should § _.13(b)(1)(i)(B) not be removed from the Final Rule, we suggest the following **new criteria** be added to § _.13(b)(2)(ii)(B)(2) in order to prevent rule evasion (additions in italics):

> § _.13(b)(2)(ii)(B)(2) is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, that covered fund, *provided that*:
>
> *(i) No "hedge" is permitted during the one year following the establishment of the fund.*
>
> *(ii) All proceeds from the "hedge" must be paid entirely to the investment advisor, and*
>
> *(iii) The "hedge" in the covered fund does not exceed 3 percent of the total outstanding ownership interests in the fund;*

There are two major problems with this risk-mitigating hedging of compensation arrangements. The first is that it is a clear **violation of the statute**. The second is that not only is such unfettered ownership interest hardly a hedge, but worse, **it is a loophole that would allow banking entities to subvert the Covered Funds restrictions almost entirely.**

a. No Statutory Authority for Hedging Compensation Arrangements

The statute does **not** provide for hedging "exposures" or "arrangements." Rather, the statute only permits hedging if it is directly tied to a position, contract or holding of a banking entity. Section 619(d)(1)(C) of the statute reads:

> Risk-mitigating hedging activities in connection with and related to **individual or aggregate positions, contracts, or other holdings** of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.

The statute only permits hedging if it is directly tied to a **position, contract** or **holding** of a banking entity. The "positions, contracts or other holdings" language of the statute is related to

items that go in the bank's *trading account*. A compensation arrangement does **not** go into the trading account, and thus is outside the realm of the hedging exemption provided in Section 619(d)(1)(C) of the Act. Thus, we suggest that § _.13(b)(1)(i)(B) be removed from the Final Rule.

b. Ownership Interests in Covered Funds are not a Hedge to Compensation Arrangements

The notion that taking on an ownership in a covered fund would offset the "exposure" the bank has due to the banking employee being compensated with carried interest is shaky at best. Presumably, this "exposure" is to either the risk of a down year where no carried interest is earned, by the investment advisor, or the risk of a claw back to previous carried interest earned, or both.

The banking entity taking on an ownership interest in this same covered fund would hardly mitigate this "exposure." Instead, it is closer to doubling down. In up years, the employee or banking entity would receive compensation in the form of carried interest due to its services to the fund **and** due to its ownership interest. In down years, the employee or banking entity would not get paid and the banking entity's investment would **decrease in value.** The so-called "hedging" of a deferred compensation arrangement for an employee who is already paid through carried interest is such a stretch that **even SIFMA puts "hedges" in quotes**.[96]

The NPR insists that the "hedge" for the compensation arrangement "[m]aintains a substantially similar offsetting exposure to the same amount and type of ownership interest, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate."

However, the NPR provides no guidance on what constitutes an "offsetting exposure" to a compensation arrangement, instead deferring to the banking entities' "written hedging policies and procedures"[97] and their "internal controls."[98] Without such guidance, it seems that even a 100% ownership interest in a covered fund could be argued to be a risk-mitigating hedge under the NPR.

The permitted risk-mitigating hedging allowance as written is a means for banking entities to completely subvert the intent of the restrictions of Subpart C. Dangerous allowances have already been provided in the statute to permit banking entities to continue their profitable asset management business. In response, the banking entities have wasted no time ramping up these offerings, with Deutsche Bank teaming up with fund of funds Financial Risk Management,[99] and

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[96] SIFMA's Comment Letter in Advance of Notice of Proposed Rulemaking Implementing the Private Funds Portion of the Volcker Rule (Apr. 14, 2011), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=24745.
[97] Proposed Rule §_.13(b)(2)(ii)(D)(1).
[98] *Id.* at §_.13(b)(2)(ii)(A).
[99] Ahmed, *supra* note 95.

both Goldman Sachs[100] and J.P. Morgan re-drawing their org charts to move their proprietary trading units into asset management.[101] Rather than bow to pressure from SIFMA and the financial sector as a whole, the Agencies must remain true to the statutory definition of "hedge" and remove § _.13(b)(1)(i)(B) from the Proposed Rule, or at a minimum, include the additional criteria §§ _.13(b)(2)(ii)(B)(2)(i)-(iii) we have outlined in *Annexure B*. If the Agencies fail to do so, the banking entities will easily be able to sidestep the 3% limits by arguing that their ownership interests are simply necessary hedges.

2. Permitted Covered Fund Activities Outside the United States

We support the provisions of §§ _.13(c)(1) and (3), as they will prevent U.S. banks with foreign operations and subsidiaries from evading the Rule using the foreign funds exemption. They will also see to it that foreign banks with substantial U.S. operations comply with Volcker, and thus do not enjoy a competitive advantage over U.S.-domiciled banks. Finally, the provisions ensure that U.S.-based institutions cannot simply move all of their investments into foreign funds that need not adhere to the restrictions of the Volcker Rule. Failure to retain § _.13(c)(3)(iii) in the Final Rule could lead to a flight of (U.S.-resident owned) capital from the United States, and thus threaten economic growth and the financial stability of the United States.

We do ask that the Final Rule be clarified to more carefully define the terms used in the foreign fund criteria—§ _.13(c)(1), § _.13(c)(2) and § _.13(c)(3)—so as to eschew evasion based on mincing of words.

3. A Dangerously Broad and Statute-Violating Allowance in Loan Securitization

a. Removal of § _.13(d)(2) and § _.14(a)(2)(v)(B)

The exemptions for loan securitizations in § _.13(d) and § _.14(a) both contain the same dangerous item that allows not just for loans but also for **"contractual rights or assets directly arising from those loans supporting the asset-backed securities."**[102]

The statute allows for the sale and securitization of loans, and **only** for loans. The Final Rule should keep with the statute. Unfortunately, it interjects the language "contractual rights or assets directly arising from those loans," which is vague and broad enough that it could mean ABS, RMBS, CDS, or any other loan-derived product, making what is permitted by these exemptions far broader than what was directed by the statute.

There is explicit language in footnote 309 in the Supplementary Information stressing that:

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[100] Charlie Gasparino, *Goldman Already a Step Ahead of FinReg*, Fox Business News, July 27, 2010, http://www.foxbusiness.com/markets/2010/07/27/goldman-step-ahead-finreg/.
[101] Bennington, *supra* note 91.
[102] Proposed Rule §§ _.13(d)(2), _.14(a)(2)(v)(B).

> the types of derivatives permitted under § _.13(d)(3) of the Proposed Rule are not meant to include a synthetic securitization or a securitization of derivatives, but rather to include those derivatives that are used to hedge foreign exchange or interest rate risk resulting from loans held by the issuer of asset-backed securities.

This language is promising at first glance, but a close examination reveals that it refers only to § _.13(d)(3), which allows for "[i]nterest rate or foreign exchange derivatives," and **does not** refer to the language of § _.13(d)(2), which is the real problematic language that could include a synthetic securitization or a securitization of derivatives. After all, what are CDO-squared securities if not "contractual rights or assets directly arising from those loans supporting the asset-backed securities"?

The statute only allows for the sale and securitization of loans and thus the Proposed Rule should only allow for the sale of loans and loan securitizations. The language of § _.13(d)(2) and § _.14(a)(2)(v)(B) go far beyond the statutory intent. "Contractual rights or assets directly arising from those loans" could mean ABS, RMBS, CDS, or any other product, making what is allowed by these exemptions far and above what was directed by the statute. For instance, this language would create a blanket exemption for a hybrid-synthetic securitization whereby an SPV issues securities backed by certain loans and credit default swaps tied to those loans. Such credit default swaps would qualify as contracts arising from loans.

A review of the Congressional Record reveals that Congress did not intend the securitization rule of construction to include loans that "become financial instruments traded to capture the change in their market value."[103] Thus, in order to prevent a broad loophole allowing banks to have ownership interests in ABS issuers creating the same toxic products that caused the 2008 financial crisis, and in order to remain true to the statute, the Final Rule **must remove** both § _.13(d)(2) and § _.14(a)(2)(v)(B).

If § _.13(d)(2) and § _.14(a)(2)(v)(B) are not removed, they must at a minimum be made more explicit, making it clear that credit default swaps, total return swaps and any form of repos are specifically excluded from the exemption for loan securitizations.

b. Further Delineation of the Statutory Rule of Construction for Loan Securitizations

The removal of § _.13(d)(2) and § _.14(a)(2)(v)(B) is but a necessary, first-step. We recommend that the Agencies take bold action to further circumscribe the role that banking entities play in the securitization market, within the limits imposed by the rule of construction contained in section 13(g)(2) of the BHC Act.

In order to properly define the scope of the statutory rule of construction for securitizations, we propose that the Agencies adopt the following three-part definition of "ownership interest" in an exempted asset-backed security:

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[103] 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

First, any "ownership interest" by a banking entity in a SPV should fit the definition of "asset-backed security" in Regulation AB. This definition would require that the ABS be registered under the 1934 Securities Exchange Act, and would also require that the ABS not be a synthetic ABS, as synthetics are explicitly excluded from Regulation AB's ambit:

> [S]o-called 'synthetic' securitizations are not included in Regulation AB's basic definition of ABS for purposes of determining whether the security qualifies for the particularized registration, disclosure and reporting regime under the Securities Act and Exchange Act we are adopting today.[104]

Because the Proposed Rule explicitly allows banking entities to sponsor or acquire ownership interests in covered funds that are ABS issuers[105] we strongly suggest that the definition from Regulation AB be used to define an ABS.

Banking entities should not be allowed to acquire interests in covered funds that issue the very products responsible for the meltdown in 2008, as such an allowance would pose a threat to the safety of the financial system. Thus, we recommend Regulation AB as the definitional source for "asset backed security" under the Volcker Rule because the Reg. AB definition excludes synthetic securitizations. This definition would protect the stability of the banking and financial markets by preventing banking entities from owning covered funds that participate in synthetic securitizations.

Second, the Agencies should further require that any ownership interest in an SPV (issuer of an asset-backed security) be in equity only. As a preliminary matter, the Agencies should apply a three-factor economic test in order to determine whether a banking entity has an "ownership interest" in a covered fund. Meeting any of the following three factors should be sufficient to count as indicative of an "ownership interest" generally:

- The banking entity has control over the fund
- The banking entity has residual interest in the fund, OR
- The banking entity has access to distributions from the fund's excess cash flow.

Conversely, in order for an ownership interest in an ABS issuer to qualify for the exemption provided by § _.13(d) and § _.14(a)(2)(v), we recommend that all three of the above factors must be met. This interpretation would ensure that an exemption is provided only for bona fide loan securitizations in which the banking entity is actively involved, consistent with the Congressional rule of construction. Otherwise, an exemption for passive utilization of securitization vehicles would be a conduit for proprietary trading.

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[104] Asset-Backed Securities, Exchange Act Release Nos. 33-8518; 34-509405 (Mar. 8, 2005), *available at* http://www.sec.gov/rules/final/33-8518.htm.
[105] *See* Proposed Rule §§ _.13(d), _.14(a)(2)(v).

Third, the Agencies should require that any ownership interest in an SPV be capped at 5% of the residual, first-loss position in the SPV. This would allow banking entities to meet the requirements of § 941 of the Act.

E. Tier-One Capital Constraints – "Skin in the Game"

In order to adhere with Dodd-Frank Act § 941, ABS issuers are required to maintain at least a 5% ownership interest in issued securities. The NPR does not provide sufficient clarity on how this "skin in the game" requirement interfaces with the 3% tier-one capital constraint on investment in covered funds. We would like it to be made explicit in the Final Rule that any ownership interest exceeding this 5% mandate would count towards the 3% tier-one capital constraint.

F. Covered Fund Activities Determined to be Permissible - Bank Owned Life Insurance

We suggest that the Agencies remove the exemption for bank owned life insurance, as it does **not** promote the safety and soundness of banking entities or the financial stability of the United States. Past class action lawsuits settlements demonstrate that there is substantial risk of litigation. In addition, bank owned life insurance could pose a liquidity risk to the bank, as the OCC and other agencies warned in 2004.[106] Finally, it seems an egregious misuse of the authority presented by Section 13(d)(1)(J) of the BHC Act to give banking entities a blanket exemption for bank owned life insurance policies that have been shown to include "dead peasant" policies[107] that reward banks, often tax-free, when an employee dies. Thus, we do not believe there is statutory authority for the bank owned life insurance exemption, and suggest it be removed from the Final Rule. We remind the Agencies that, as per Congressional intent, Section 13(d)(1)(J) "sets an extremely high bar."[108]

G. Limitations on Relationships with a Covered Fund

1. Super 23A

We **strongly support** the "Super 23A" restriction in § _.16(a)(1). Preventing banking entities from extending credit to the covered fund is important to ensure that banking entities are not tempted to bail out a covered fund should it falter.

That said, we are concerned that § _.16(a)(1) **does** allow for the **sale** of securities by a banking entity to a covered fund. The Agencies should consider a scenario where a banking entity organizes, offers, and seeds a new fund, and then sells a substantial amount of assets to this new

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[106] Interagency Statement on the Purchase and Risk Management of Life Insurance, OCC Bulletin No. 2004-56 (Dec. 7, 2004); FDIC FIL-127-2004 (Dec. 7, 2004); Federal Reserve Board SR Letter No. 04-19 (Dec. 7, 2004); OTS TB 84 (Dec. 14, 2004).

[107] *See* Ashby Jones, *Dead Peasant' Policies: The Next Big Thing in Insurance Litigation*, Wall St. J., Feb. 24, 2009, http://blogs.wsj.com/law/2009/02/24/dead-peasant-policies-the-next-big-thing-in-insurance-litigation.

[108] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

fund. We are concerned that, as written, the NPR's allowance for the sale of securities by the banking entity to the covered fund may allow for duplicitous accounting. Thus, in addition to supporting the restrictions provided by § _.16(a)(1), we suggest that the Agencies issue an **additional** restriction that would prevent a banking entity from **selling assets** to a covered fund. The unfettered ability of a banking entity to offload undesirable assets to subsidiary covered funds would only create incentives for such a banking entity to take higher levels of risk and pursue speculative assets.

2. Prime Brokerage Transaction Must Be Limited To Third Party Funds

The Congressional Record shows that the intention behind the allowances for prime brokerage in the statute was meant to be applied to **third-party funds only.**[109]

The language of the Proposed Rule does not implement this Congressional intent, and thus must be modified to reflect that the prime brokerage allowance was only meant for third-party funds. In order to amend this breach between Congressional intent and the NPR, the Final Rule should amend § _.16(a)(2)(ii) to include the phrase "third party":

> (ii) Enter into any prime brokerage transaction with any *third party* covered fund in which a covered fund managed, sponsored, or advised by such covered banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest, if:

3. No Financing or Securities Lending in Permitted Prime Brokerage Transactions

We strongly suggest that the permitted prime brokerage transactions listed in § _.16(a)(2)(ii) **should not include** securities lending and borrowing, or financing.

Neither the Congressional Record nor the statute state that the exception for prime brokerage must include financing, securities lending or borrowing. We feel that there are considerable risks in allowing "financing" of a covered fund by a banking entity, as this may lead to the fund increasing its leverage. Finally, the statute very clearly laid out the fact that Sections 23A and 23B of the Federal Reserve Act would be used for the purpose of prohibiting "covered transactions" between a banking entity and a covered fund. One of the covered transactions described in 23A is "a loan or extension of credit."

We also suggest that a banking entity be required to reduce its ownership interest to the 3% *de minimis* limit before it is allowed to serve as a prime broker to the covered fund.

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[109] *Id.* at S5898 ("Subsection (f), paragraph (3) permits the Board to allow a very limited exception to paragraph (1) for the provision of certain limited services under the rubric of 'prime brokerage' between the banking entity and a third- party-advised fund in which the fund managed, sponsored, or advised by the banking entity has taken an ownership interest.").

4. 23B and Market Terms for Prime Brokerage Transactions

Despite our issues with the prime brokerage transaction allowances, **we strongly support the requirements outlined in § _.16(b) and § _.16(c),** which require that services and transactions between the banking entity and a covered fund to be on market terms or on terms at least as favorable to the banking entity and the covered fund "as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies."[110]

Were § _.16(b) and § _.16(c) not present in the Rule, a banking entity could sell distressed assets to a covered fund at above-market prices. We feel it is very important to retain § _.16(b) and § _.16(c) in the Final Rule in order to prohibit abuses of the covered fund exemptions.

[110] 12 U.S.C. § 371c–1(a)(1)(A) (2011).

V. RECORD-KEEPING AND COMPLIANCE

A. Reporting Scope and Timeline

1. Excluded Activities Must Also Require Reporting

One of our chief concerns with the Rule as written is that it threatens in some cases to not just enable but also incentivize certain types of evasion. For that reason, we feel it is imperative that **all** trading, regardless of any trading account exclusion, be subject to quantitative-measurement and risk-reporting requirements. Excluding currently traded instruments, such as structured repurchase and reverse repurchase agreements, from measurement and reporting requirements will create a major incentive for banking entities to engage in risky "financial engineering" in order to evade requirements.

2. Clarification of the $1 Billion Threshold Calculation

Our understanding is that the NPR considers only "covered trading activities" as counting toward the $1 billion threshold that triggers the reporting and record-keeping requirements of the Volcker Rule. For similar reasons to those quoted above, we feel that the Agencies should instead 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 Rule's reporting and record-keeping requirements.

3. Reporting Should Begin Immediately

It is our strong conviction that the stated timeframe for beginning the reporting requirements is more than adequate. Within the banking industry, it is general knowledge that the 2008 financial crisis inspired almost all banking entities to begin drafting institutional aggregate risk-measurement programs. With this in mind, it seems that any complaints about overaggressive implementation schedules are likely to be politically rather than functionally motivated.

4. Recordkeeping Requirement Consistency

While we feel that the proposed retention-of-records requirement[111] is a necessary concept and should be retained, we do feel that it is currently inconsistent with relevant state laws. While the current statute of limitations on civil suits for Fraud, Contracts and Collection of Debt on Accounts in New York State is **six** years,[112] the proposed language only requires the retention of records for "no less than 5 years." Given the significant financial-industry presence in New York, we feel that the NPR should ensure that the minimum record-retention language is consistent with the New York State law cited above.

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[111] Proposed Rule § _.20(b)(6).
[112] N.Y. Civ. Prac. L. & R. § 213 (2012).

We have added this suggested change to *Annexure B.*[113]

5. Clarification of Vague Language

We feel that § _.20(b)(1), requiring "[i]nternal written policies and procedures reasonably designed"[114] to ensure compliance with the NPR, could be further strengthened. Specifically, we feel that linking the language on "reasonable assurance" and "reasonableness" to similar existing language in Sarbanes-Oxley[115] would make the Proposed Rule both more effective and more consistent with other regulation.

Language in Appendix C, Element III could also be made clearer. In a delineation of minimum criteria, the Rule states that when any quantitative measurement raises a concern regarding compliance with section 13 of the BHC Act, there should be both an immediate internal review and escalation, and "timely notification to [Agency]."[116] We feel that "timely" is insufficiently clear here. We feel that the Rule should directly require the banking entity to **immediately** notify the [Agency]. For additional clarity, we recommend that the Agencies explicitly require such notification to occur no later than one day after the concern is raised internally.

As long as banking entities are complying with the Rule, this requirement should not be unduly burdensome. The robust internal reporting measures necessary should already be in place.

B. Structure of Programmatic Compliance Regimes

1. Internal vs External Independent Testing

Although we are strong supporters of the fourth listed element, independent testing, we have concerns about the practical implementations of both listed approaches. We therefore urge the Agencies to conduct monitoring of each approach with extreme vigilance.

With respect to internal testing, we feel testing by qualified banking entity personnel will be most effective if performed by a banking entity's Internal Audit personnel. These employees, usually respected (and appropriately feared) within a banking entity, have the auditing expertise, internal authority, and institutional knowledge required to conduct effective testing. Since the NPR does not provide clear monetary penalties, however, we are concerned that internal audit teams may lack the usual incentive (avoiding substantial loss to the firm from monetary sanctions) that ensures their zealous enforcement of other regulatory provisions.

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[113] The proposed elements are generally very effective and should all be retained in the Final Rule. It is important to retain them because failure to do so would make evasion of the rule substantially easier.
[114] Proposed Rule §_.20(b)(1).
[115] *See* Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 72 Fed. Reg. 35,324, 35,324 (June 27, 2007) (codified at 17 C.F.R. pt. 241 (2008)).
[116] NPR at 68,966.

With respect to external testing, we are concerned about an outside parties' lack of firm-specific knowledge. While we do not doubt that these outside entities will scrupulously carry out their measurements, we feel that their lack of expertise in areas such as account structuring, technological specifics, and unit responsibilities will make it difficult for them conduct effective reviews. Regardless of which approach a banking entity uses to comply with § _.20(b)(4), we ask that the Agencies remain vigilant and ensure that the implementation of any testing is adequate.

As an alternative, we suggest that the Rule require regular monitoring by the internal audit team, supplemented by yearly external reviews with strict, verified independence. Additionally, we would suggest that all internal compliance professionals be subject to a Volcker-specific licensing and registration process similar to FINRA's Series 14[117] for NYSE compliance officers. Such standardized licensing processes ensure that a basic level of proper skills, knowledge, and accountability is shared by all relevant personnel throughout the industry.

2. Enterprise-wide Compliance Programs

Since all divisions of the banking entity will be involved in the record-keeping and decision-making required by certain sections of the rule, including Appendix C's elements VI (training), Internal Policies and Procedures (II) and Record Keeping (VII), we feel that these sections would fit excellently into an enterprise-wide compliance program. However, it is our opinion that an enterprise-wide compliance program will only be effective if combined with additional programs at the trading unit or subsidiary level.

In our collective experience working at banking entities, the most successful enterprise-wide compliance programs we have encountered are the anti-money-laundering and anti-sexual-harassment training programs offered at financial institutions. Since all employees are required to learn the risks, indicators and possible consequences of money laundering, these programs generally achieve excellent results. A similar program, combining electronic informational materials and a progression of case studies with attendant questions, might be effective in ensuring Volcker Rule compliance. Any such training program should be sure to train all employees at a banking entity in prohibited activities, permitted activities, and next steps in the event of a suspected violation.

We do not believe that Appendix C's elements III (Internal Controls), IV (Responsibility and Accountability), V (Independent Testing) and VII (Record Keeping) should occur solely at the enterprise level. In Element IV (Responsibility and Accountability), for example, the NPR outlines many specific levels of responsibility (including Trader Mandates and Business Line Managers) that would be difficult or impossible to track solely at an enterprise-wide level.

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[117] The Series 14 examination, administered by FINRA, is a qualification examination intended to insure that the individuals designated as having day-to-day compliance responsibilities for their respective firms or who supervise ten or more people engaged in compliance activities have the knowledge necessary to carry out their job responsibilities. FINRA, FINRA Registration and Examination Requirements, http://www.finra.org/industry/compliance/registration/qualificationsexams/registeredreps/p011051 (last visited Feb. 5, 2012).

Mandates from high in an organizational hierarchy may not address the specifics of an individual business line. Compliance with hedging exemption criteria will be much different for Global Corporate Bond Trading units than for European Equity Derivatives units.

For this reason, we believe enforcement must occur at the enterprise-wide and department-specific levels. Enterprise-only enforcement may dilute materiality at unit levels: a material breach at a subsidiary unit may not be material at the enterprise level. To prevent individual desks with small dealings from evading the Rule, then, any Internal Control program should also be present at the trading unit level with oversight from senior management, compliance, and internal audit officials.

We feel it would be inefficient to mandate an enterprise-wide model of Internal Controls. Since each trading unit is different, quantitative measures may vary widely in their value and applicability to each individual unit. We suggest it would be more efficient to mandate enterprise-wide default Internal Controls, but require each individual trading unit to tailor these requirements to its own specific business. This tailoring, performed with the consent of internal compliance workers, would ensure that trading units do not attempt to subvert the Rule.

3. Burdens and Redundancies

It is likely that a vast majority of banking entities have existing compliance programs that are not substantially different in structure from the one described in this Proposed Rule. The level of detail, however, can be expected to diminish commensurate with levels of risk exposure.

If banking entities willingly and seriously move to implement the necessary changes to their relevant businesses to conform to these rules, there should be minimal need for substantial changes to current compliance staff. If, however, banking entities move to restructure in order to subvert or evade the regulation, the job of the compliance department will become exponentially more difficult, and under these circumstances compliance departments may require substantial additional resources.

In our general opinion, the specific requirements of this Proposed Rule are sufficiently basic that if meeting these standards for a given trading activity poses a significant burden on a banking entity, then that trading activity would most likely be considered inappropriate for it to conduct in any case.

Any truly thorough system will include a certain amount of overlap, and we find no redundancies in the Proposed Rule that do not serve to strengthen the overall program. The requirements in each Appendix are mutually reinforcing. For example, the quantitative measurements do much to provide an overview of a trading unit's risk profile, but fail to identify inappropriate hedging activity. The compliance requirements in Appendix C provide much more specific information as to the nature of compliant trading activity. While each provision separately may not provide sufficient clarity for an analysis of an entity's general compliance, in concert they seem to provide robust regulatory coverage.

4. CEO Certification

We recommend that, consistent with the recommendations of the FSOC Study, CEOs should be required to provide yearly certification that the compliance program is adequate and effective, as this will "ensure the highest level of accountability."[118] It is our strong conviction that it will be difficult to effect real change at banking entities without committed leadership from the very top. This provision, in addition to being extremely practical, does nothing but hold banking entity executives to the same standards that many Americans in other sectors of the economy meet each day: taking responsibility for the work that occurs under their watch.

We also call for the establishment of a central repository for CEO attestations to the Agencies. In addition, the Agencies should require that Question 346's suggested supervisory methods (i), (ii) and (iii),[119] be adopted and implemented by the banking entities. The use of these thorough procedures within the banking entity's supervisory channels will ensure that the Agencies, often constrained by limited resources,[120] are included in the compliance process in the most effective way possible.

C. Special Concerns

1. Reporting and Compliance for ABS Issuers

In light of recent and ongoing scandals in the mortgage market specifically,[121] it is clear that negligent record keeping and minimal oversight would present significant challenges to the implementation of the proposed compliance regime. While this would certainly be problematic, it is the clearest possible demonstration of the dire importance of ***all*** banking entities adhering to such a system. Since mortgage securities are often the riskiest within existing ABS issuer portfolios, we feel it would be tremendously irresponsible of the Agencies to lose their focus on these issues. We urge the abandonment of any inclination to relax these requirements for any trading activities.

In our view, banking entities that own existing issuers of asset-backed securities must face a choice. Either banks must find a way to fully comply with the Proposed Rule's requirements, or they must divest their ownership in such issuers. A blanket exclusion for existing asset-backed-

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[118] FSOC Study, *supra* note 29. at 36 ("Agencies should also strongly consider requiring the CEO to attest publicly to the ongoing effectiveness of the internal compliance regime. This will ensure the highest level of accountability for the satisfaction of these expectations.").

[119] NPR at 68.922 (Question 346) ("(i) A chief compliance officer or similar officer present an annual compliance report including, as appropriate, recommended actions to be taken by the banking entity to improve compliance or correct any compliance deficiencies; (ii) the board review any such recommendations and determine whether to approve them; and (iii) the banking entity notify the relevant Agency if the board declines to approve such recommendations, or approves different actions than those recommended in the compliance report.").

[120] FSOC Study, *supra* note 29. at 44 ("[S]ome Agencies face significant resource constraints and that incorporation of these components, which include a review of trading practices to identify prohibited trading and distinguish permissible trading, would require significant new and specialized resources.").

[121] *See* Brady Dennis & Ariana Eunjung Cha, *In Foreclosure Controversy, Problems Run Deeper than Flawed Paperwork*, Washington Post, Oct. 7, 2010, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/10/06/AR2010100607227.html.

security issuers is clearly at odds with the intentions of the statute to promote transparency and oversight in risky securities. We believe the Agencies should not be concerned with the means by which these necessary compliance procedures are internally funded.

VI. LIMITATIONS ON PERMITTED ACTIVITIES

A. Conflicts-of-Interest

1. Conflicts with Depositors

Based on *current* banking practice, market making, underwriting, hedged trading, and the rest of the permitted activities listed in Section 619(d)(1) all run afoul of the limitation contained in Section 619(d)(2)(A)(i). That limitation states that banking entities may not rely on any Volcker Rule exclusion if doing so would result in a material conflict of interest with "customers." Depositors should fall within the definition of "customers" since banks provide them with depository services. Virtually all banking entities that engage in market making and other exempted activities fund these activities, at least indirectly, with depositors' funds. However, depositors are never compensated for the usage of their funds when banks earn money from proprietary positions, which is a conflict of interest.

When depositors post money at banks, that money does not remain in a vault. Rather, it is utilized by banking entities to make loans, pay off expenses, and otherwise create an infrastructure through which to *conduct proprietary trades*. Thus, banks stand to gain from the leverage provided to them by depositors. Unfortunately for depositors, this provision of leverage remains uncompensated. This point was cogently recognized by Congressman Keith Ellison during the Congressional House Committee on Financial Services' recent hearing on the Volcker Rule:

> In the absence of something like Volcker Rule, we have a head I win, tails you lose system in which, if I'm a bank I can go out and buy mortgage-backed securities ("Triple A rated") . . . they make a bunch of money, I keep that, I do not give that to those depositors, [whose money] I use. . . . But if I lose a bunch of money, I'm coming to the taxpayer to save me. And it seems so unfair.[122]

Burton's Legal Thesaurus states that a "conflict of interest" exists where a party faces a divergence of interests with respect to clients.[123] We know of no bank that repays FDIC-insured depositors for usage of their money in the form of participation interests on the proceeds from proprietary trading. This is an exploitative situation wherein the resources of one party are utilized by another, without just compensation—a clear "divergence of interests." Thus, simple logic dictates that depositors must be granted some monetary participation in any gains achieved by a banking entity from exempted activities like market making. Absent such a participation, Section 619(d)(2)(A)(i) would bar <u>all</u> proprietary trading by covered banking entities.

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[122] U.S. House, Committee on Financial Services, *Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Hearing*, Jan. 18, 2012, *available at* http://mfile3.akamai.com/65722/wmv/sos1467-1.streamos.download.akamai.com/65726/hearing011812.asx.

[123] William C. Burton, Burton's Legal Thesaurus (2007).

2. Congressional Intent Behind Section 619(d)(2)(A)(i)

Even if the Agencies decline to adopt this interpretation, we have various other concerns with the Proposed Rule's implementation of the Section 619(d)(2)(A)(i) backstop. For instance, the Agencies have impermissibly interposed disclosure and information barriers into the Proposed Rule as curative measures to address conflicts-of-interest. Section 619(d)(2) contains no mention of information barriers or disclosure, and it appears that the Agencies have added these components into the conflict-of-interest backstop without any statutory justification.

There is evidence that Congress purposely excluded disclosure and information barriers as rehabilitative measures to address conflicts of interest. First, the Congressional Record relating to the passage of Section 619 is devoid of any mention of these concepts. Second, the legislative intent behind Section 621, which is indirectly related to and was passed alongside Section 619, is illuminating on this point. Senator Levin expressly rejected the usage of disclosure as potentially curative of conflicts of interests in asset-backed security underwritings:

> [A] firm that underwrites an asset-backed security would run afoul of the provision if it also takes the short position in a synthetic asset-backed security that references the same assets it created. In such an instance, even a disclosure to the purchaser of the underlying asset-backed security that the underwriter has or might in the future bet against the security will not cure the material conflict of interest.[124]

Congress had the opportunity to include disclosure and information barriers into Section 619, and it chose not to do so. The Agencies must follow suit. An administrative agency exceeds its authority when it considers regulatory options that have been purposely dismissed by Congress.[125]

3. The Ineffectiveness of Disclosure

Disclosure is an ineffective remedy for numerous reasons. First, disclosure has limited utility where the potential wrongdoer is the party that is given the responsibility of providing the relevant information to investors. If a banking entity has engineered a proprietary trade with the express intention of taking advantage of customers, it will not meaningfully disclose that fact. Banks will only willingly disclose meaningless or benign information. In a recent speech at Fordham Law School, Securities and Exchange Commissioner Troy A. Paredes recognized that disclosure can be useless in some cases, especially where the sheer volume of the disclosed material militates against actual comprehension of risk.[126] Even where disclosed information is meaningful, the relevant bits of information may be buried in a sea of paper that would

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[124] 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).
[125] *See Levine v. Apker*, 455 F.3d 71, 80 (2d Cir. 2006) ("[W]e will not defer to an agency's interpretation that contravenes Congress' unambiguously expressed intent.").
[126] *See* Troy A. Paredes, Address at Twelfth Annual A. A. Sommer, Jr. Lecture on Corporate, Securities and Financial Law, Fordham Law School (Oct. 27, 2011) (speech given in Securities and Exchange Commissioner Paredes's individual capacity).

effectively pre-empt actual comprehension of risk by investors. For instance, in its investigation of Citigroup's Class V Funding III collateralized debt obligation ("CDO"), the SEC learned that Citigroup had disclosed to investors in its pitch book and offering circular that it had taken a short position in the underlying credit derivative.[127] The SEC nevertheless continued the investigation, which culminated in a $285 million settlement.[128]

Disclosure is particularly ineffective in illiquid markets because these markets typically feature information asymmetries or pricing obscurities. Banking entities with even the best of intentions simply may not have enough information to disclose material conflicts-of-interest. The example of Long Term Capital Management will demonstrate that even sophisticated parties may not be aware of or fully appreciate the risks involved in their own activities.[129]

Further, even if banking entities were able to identify and disclose conflicts of interest in their proprietary trading activities, their customers may not be able to appreciate or digest such disclosures. The savviest of institutional investors may not have sufficient resources or access to information to verify the contents of disclosure documents, especially within the context of highly illiquid markets. Many investors simply presume that disclosed information is accurate, relying on the underwriter's reputation as an information proxy.[130]

At § _.8(b)(1)(ii), the Proposed Rule further dilutes the impact of the conflict-of-interest backstop, by allowing disclosures to "negate**, or substantially mitigate,** any materially adverse effect on the client."[131] If the Agencies retain a role for disclosure as curative of conflicts-of-interest, despite the above-mentioned arguments, they should at the very least strike ", or substantially mitigate," out of § _.8(b)(1)(ii). Put simply, banks should be required to negate any materially adverse effects on clients, and not just "substantially mitigate" those effects. A "substantial mitigation" standard would effectively condone minor-yet-materially adverse effects of conflicts of interest on banking clients. This interpretation is at odds with the customer-focused motivation behind the Volcker Rule.

4. The Ineffectiveness of Information Barriers

Information barriers also have limited usefulness in curing conflicts-of-interest. The NPR notes that information barriers are currently used as a means to address conflicts-of-interest in other securities law contexts. The implication is that these information barriers are effective tools in promoting a culture in which the interests of investors are paramount and sensitive information is not exploited for gain. However, despite the existence of these barriers, front running occurs routinely. Every few months the financial pages are replete with stories of how so-called "rogue

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[127] *Sec. & Exch. Comm'n v. Citigroup Global Markets Inc.*, SEC Litigation Release No. 22134 (Oct. 19, 2011).
[128] *Id.* The Southern District of New York later rejected the SEC's application to confirm this paltry settlement figure, because such a confirmation would turn the courts into "an agent of oppression." *See SEC v. Citigroup Global Markets Inc.*, Case No. 11 Civ. 7387, slip op. at 15 (S.D.N.Y. filed Nov. 28, 2011).
[129] *See generally* Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (2001).
[130] Andrew T. Tuch, Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs 57 (Apr. 2011), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Tuch_37.pdf.
[131] Proposed Rule § _.8(b)(1)(ii) (emphasis added).

traders" are able to circumvent information barriers and other controls to lose billions of dollars in highly risky transactions, at the expense of clients.[132] Academics have also amassed empirical evidence questioning the efficacy of information barriers.[133] Such studies have found that even where information barriers are erected, regulators are routinely unaware of when such barriers have been breached.[134] Information barriers are a regulatory tautology, in that regulated entities are essentially asked to police themselves and to report non-compliance.[135]

In some cases, information barriers actually undermine the efficacy of disclosure as a tool to cure conflicts of interest. In a recent class-action lawsuit, J.P. Morgan Chase ("JPM") was sued by former investors in a troubled investment vehicle called Sigma.[136] The plaintiffs in that lawsuit alleged that JPM knew about Sigma's impending demise, yet failed to alert them of that fact. JPM made handsome profits from the collateral held by Sigma after that investment vehicle ultimately failed. This case seems to present a classic case of conflict of interest. However, JPM has argued in court that its information barriers actually **precluded** it from providing the plaintiffs with the disclosures necessary to protect their interests.[137] "The bank argues that by law, different units of the company that dealt with Sigma could not share information, because of so-called Chinese walls, which are meant to prevent the spread of nonpublic information within the firm."[138] If JPM is to be believed, information barriers actually make conflict mitigation more difficult, especially where conflicts arise from activities in different units within a banking conglomerate. Therefore, the Agencies should seriously question whether information barriers have any curative utility in conflicted transactions.

5. Enforcement: Limitation on Banking Entity Size

The conflict of interest limitation can also be seen as a jurisdictional justification for the imposition of size limits on banking entities that seek to conduct covered activities under one of the exemptions. Opportunities for front running abound in larger organizations. At larger banks, it is easier to couch front running as mere fortuitous gains derived from independently acquired information. This kind of obfuscation is more difficult in smaller banks, since customers are likely to have more visibility into a smaller bank's operations. As the JPM-Sigma case demonstrates, the larger the bank, the easier it is for that bank to claim that assertedly conflicted actions were justified by the presence of information barriers. We recommend that the Agencies impose a size restriction on banking entities relying on a proprietary trading exemption. A

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[132] Jesse Eisinger, Propublica, *In Fight Against Securities Fraud, S.E.C. Sends Wrong Signal*, N.Y. Times Dealbook, Oct. 26, 2011, http://dealbook.nytimes.com/2011/10/26/in-fight-against-securities-fraud-s-e-c-sends-wrong-signal/.
[133] *See* Tuch, *supra* note 130, at 32.
[134] *Id.*
[135] *See* David S. Hilzenrath, *Justice Department, SEC Investigations Often Rely on Companies' Internal Probes*, Washington Post, May 22, 2011, *available at* http://www.washingtonpost.com/business/economy/justice-department-sec-investigations-often-rely-on-companies-internal-probes/2011/04/26/AFO2HP9G_story.html ("As the U.S. government steps up investigations of companies suspected of paying bribes overseas, law enforcement officials are leaving much of the detective work to the very corporations under suspicion.").
[136] Louise Story, *JPMorgan Accused of Breaking Its Duty to Clients*, N.Y. Times, Apr. 10, 2011, http://www.nytimes.com/2011/04/11/business/economy/11bank.html.
[137] *Id.*
[138] *Id.*

suitable limitation would be $5 billion in trading assets and liabilities, which is the Proposed Rule's threshold for enhanced record-keeping duties. Such a restriction would be one of the most effective ways—certainly more effective than disclosure or information barriers—for banks to avoid conflicts of interest with clients.

6. Enforcement: Imposition of a Fiduciary Duty

The Proposed Rule's definition of conflict-of-interest is under-inclusive because it fails to sufficiently delineate the contours of what does and what does not constitute a conflict of interest. By creating a vague standard with little direct precedential value, the Agencies have not provided market participants with any usable guidelines with which to conform their conduct. We propose that the Agencies redress this deficiency by imposing an explicit fiduciary duty on any banking entity relying on a Section 619(d) exemption. Such an imposition is justified on two grounds:

a. the requirement that permitted proprietary trading be client-oriented is tantamount to the imposition of a fiduciary duty, and

b. the Section 619(d)(2)(A)(i) ban on conflicts of interest in permitted activities imposes a heightened relationship of trust between a bank and its client, consistent with a fiduciary standard.

a. Client-oriented Activities

In a normal arms-length transaction, a banking entity must only satisfy a relatively simple, anti-fraud standard in its dealings with clients and counterparties. In such transactions it is understood that the parties have divergent interests, and that one party does not safeguard the interests of the other. This arms-length scenario does **not** apply to transactions permitted under Section 619(d). That Section requires that any banking entity performing permitted proprietary trading activities meet a fiduciary standard with respect to its clients.

The Congressional Record reveals that the purpose behind the Section 619(d) exemption was to allow proprietary trades only if they were "safer, client-oriented financial services."[139] This focus on client-oriented services is markedly different from the typical arms-length relationship that undergirds most banking activities. In an arms-length transaction, the bank's focus is on its own bottom line. In a client-oriented transaction, the bank's focus must be on the client's bottom line; otherwise that transaction would not be "client-oriented." In other words, the legislative intent was to force banks conducting exempted activities to align their interests with those of their clients.

The client-oriented duty that is imposed on banking entities relying on Section 619(d) can fairly be described as a fiduciary duty. Black's Law Dictionary defines "fiduciary duty" as "a duty obligating a fiduciary (as an agent or trustee) to act with loyalty and honesty and in a manner

[139] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).

consistent with the best interests of the beneficiary."[140] That is, a fiduciary must promote the client's best interests. Similarly, as per Congressional intent, a banking entity operating under one of the Section 619(d) exemptions must also promote the client's best interests. Thus, Section 619(d)'s emphasis on the client's best interest is entirely consistent with the concept of fiduciary duty. Indeed, concern for another's interests ahead of one's own is the hallmark characteristic of a fiduciary duty.

b. Heightened Relationship of Trust

The Volcker statute also imposes a fiduciary standard by operation of the plain language of the conflict of interest backstop contained in Section 619(d)(2)(A)(i). That provision holds that activities otherwise permitted under Section 619(d) are banned if they would result in a "conflict of interest." This restriction contemplates a heightened relationship of trust between a bank and its client, which is consistent with a fiduciary standard.

The default rule for banks executing proprietary trades is that the bank is free to have gross conflicts of interest with its clients (provided there is no fraud). Section 619(d)(2)(A)(i) changes this default rule with respect to Section 619(d) exempted activities. By imposing a limitation on conflicts of interest, Section 619(d)(2)(A)(i) imposes a **heightened burden** on bank engaging in exempted activities. Under this heightened burden, a bank must align its interests with those of clients, so as to avoid material conflicts of interest. This alignment of interests, which is imposed by statute, is suggestive of a close, trusting relationship between the bank and its clients. As discussed above, the legislative history confirms that Congress intended to impose just this type of close, trusting relationship in this context. Case law holds that where clients expect a heightened level of trust from financial services providers, a fiduciary duty is imposed.[141] That is, the existence of a relationship of trust can give rise, *sua sponte*, to a fiduciary duty benefiting the client. Thus, it can be argued that Section 619(d)(2)(A)(i)'s limitation on conflicts of interest creates a fiduciary duty for any banking entity conducting exempted activities under Section 619(d).

This proposition is not unprecedented. In other areas of law, bans on conflict of interest go hand-in-hand with fiduciary duty. For example, in the context of corporate law, the fiduciary duty placed on a company's director requires a purposeful alignment of interests by that director. The director must refrain from privileging his personal financial interest over that of the corporation in making decisions.[142] In other words, the director must not allow a conflict of interest to taint his actions, as that would be a breach of fiduciary duty. Similarly, an attorney's

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[140] Merriam-Webster's Dictionary of Law (1996).

[141] *See Breakaway Solutions, Inc. v. Morgan Stanley & Co.*, No. Civ. A. 19522, 2005 WL 3488497, at *2 (Del. Ch. Dec. 8, 2005) (""To the extent that underwriters function, among other things, as expert advisors to their clients on market conditions, a fiduciary duty may exist."). *See also EBC I,Inc. v. Goldman, Sachs & Co.*, 19, 832 N.E.2d 26, 31 (2005) ("[A] cause of action for breach of fiduciary duty may survive, for pleading purposes, where the complaining party sets forth allegations that, apart from the terms of the contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone.").

[142] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) ("Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally").

fiduciary duties severely limit her ability to be involved in matters giving rise to a conflict of interest, given that a client's interest must be held as paramount.[143] Analogously, the Section 619(d)(2)(A)(i) conflict of interest limitation also requires an alignment of interests between bank and client, and is therefore consistent with the concept of fiduciary duty.

Practically speaking, a fiduciary duty would benefit both banks and the regulators charged with ensuring compliance with the Volcker Rule. The fiduciary standard is backed by centuries of interpretive common law. This well-established body of precedent would serve as an objective yardstick with which banking regulators and compliance officers could measure bank conduct. We are aware that Section 913 of the Act has raised the possibility of a uniform fiduciary standard for all financial advisers. Still, the Agencies should recognize that Section 619 imposes a fiduciary duty on banks for any Section 619(d) permitted activities, irrespective of and separate from Section 913.

7. Enforcement: Disgorgement of Principal Gains

The conflicts of interest provision justifies automatic disgorgement of money that banks earn from price movements while conducting Section 619(d) permitted activities.[144]

The Proposed Rule strains logic by claiming that "the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests would not be deemed a 'material' conflict of interest with respect to [Section 619(d) permitted] transactions." Frankly, this makes no sense. The fact that a buyer and seller are on opposite sides of a transaction **necessarily** means that they have a significant conflict simply because a typical trade between a buyer and seller is a zero-sum game. In fact, the two parties in a trade are materially[145] conflicted in their objectives whenever there is a possibility that one side will win, and the other side will lose on the transaction. The only permissible way that a bank and a client could be on different side of a transaction without there being a material conflict of interest is if the bank were to lose on the transaction **every time**. This presents the Agencies with two options:

1. Mandate that the Section 619(d) permitted activities can never be done if a banking entity is on one side of a transaction and its client is on the other side (in recognition of the fact that the bank will win sometimes, to the detriment of the client), or
2. Allow a bank and its client to be on opposite sides provided that the bank is required to disgorge to the client any profits made from the transaction. This would nullify the effects of the conflict.

It should be noted that the bank's fees for services would not be subject to disgorgement since there would be no conflict over such fees. The client has no legitimate right to the bank's fees for services rendered. However, the client certainly would have a right to claw back profits from price movements in retained principal risk.

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[143] ABA Model Rules of Prof'l Conduct R. 1.7.
[144] The tool of disgorgement is discussed above in the underwriting and market-making sections.
[145] Indeed, the prospect of gain (or loss) on a transaction is probably the most "material" aspect of any trade.

B. High-Risk Assets

The Proposed Rule is ineffective because it does not properly define the term "high-risk asset." The term is defined to include "an asset or group of related assets that would, if held by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail."[146] The NPR perplexingly avoids explicitly defining the term to include "illiquid assets." Illiquid assets certainly fit the bill as assets that substantially increase the likelihood of bank failure. For proof, the Agencies need look no further than the example of Lehman Brothers, which collapsed largely under the weight of its risky bets in illiquid markets.[147]

Credit derivatives should also be designated, pro forma, as "high risk assets." The role that these instruments played in the recent financial crisis has been well documented.[148] Essentially, **credit derivatives are insurance products free from the protections of insurance regulation**. As such, they pose a grave threat to the American economy (not to mention bank depositors), and should be covered by the Volcker Rule's restrictions. For similar reasons, synthetic securities that derive their value from other assets or liabilities should also be considered "high risk."

As discussed in detail above, repurchase agreements and securities lending transactions can contain in-built proprietary positions. The structured varieties of these transactions are especially dangerous, because they are typically connected with very heavy leveraging, all the while being misconstrued for capital adequacy purposes as mere "secured loans."

Although securities issued by certain government-sponsored enterprises (GSEs) are exempted by Section 619, the Agencies should require a banking entity seeking to trade such securities to first file a transaction-specific application with the Federal Reserve to get pre-clearance based on an assessment of the risks involved in that transaction. High-risk mortgage purchases and guarantees by GSEs helped fuel the recent housing bubble and financial crisis.[149] The GSEs played a pernicious role in the recent economic crisis, and securities issued by these entities should not be given the same preference that is afforded to U.S. Government Treasury bonds. In September 2008, the U.S. Treasury placed Fannie Mae and Freddie Mac into conservatorship. Any securities issued by these enterprises have "bailout" written all over them.

For similar reasons, the Agencies should require an interpretive determination by the Federal Reserve before a banking entity is allowed to trade in municipal bonds. Even large municipalities have teetered on the verge of default in the past.[150] For instance, New York City

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[146] Proposed Rule § _.8(c)(1).
[147] *See* Abigail Field, *Lehman Report: The Business Decisions That Brought Lehman Down*, Daily Finance, Mar. 14, 2010. http://www.dailyfinance.com/2010/03/14/lehman-report-the-business-decisions-that-brought-lehman-down/.
[148] Jesse Eisinger, *The $58 Trillion Elephant in the Room*, Portfolio.com, Oct. 15. 2008. http://www.portfolio.com/views/columns/wall-street/2008/10/15/Credit-Derivatives-Role-in-Crash/.
[149] Dwight M. Jaffee, The Role of the GSEs and Housing Policy in the Financial Crisis (Feb. 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0227-Jaffee.pdf.
[150] Marilyn Cohen, *Municipal Bonds: Armageddon Or Opportunity?*, Forbes.com, Jan. 19, 2009, http://www.forbes.com/2009/01/17/municipal-bonds-bankruptcy-pf-in_mc_0119tmunibonds_inl.html.

almost defaulted on its debts in 1975. The same was true for Cleveland in 1978. Orange County, California famously filed for bankruptcy in 1994. The risk of default is exacerbated in smaller municipalities with fewer resources available to them as recourse. Issuances by small municipalities are also more susceptible to outright fraud. "JPMorgan Chase & Co. (JPM)'s Charles LeCroy said the key to landing bond deals in Jefferson County, Alabama, was finding out whom to pay off."[151] The exemption at § _.6(a)(ii) conveys the impression that bonds issued by the United States Treasury are considered as safe as bonds issued by even the smallest, remotest political subdivisions of States. Such is simply not the case.

We further recommend that the Agencies focus their attention on traditionally "low risk" assets as well, for a number of reasons. For one thing, "low risk" exposures are subject to lower capital reserves, which magnifies the potential fallout from unexpected defaults. Moreover, ostensibly "low risk" exposures end up being so designated across all banks that utilize similar risk-weighting methodologies. Correlations in pricing methodologies across banks thereby amplify the consequences of default. Indeed, the Agencies should apply the greatest scrutiny to exposures that are designated as "low risk" by third parties, such as rating agencies, especially where those parties have financial incentives to issue unduly favorable ratings.

The recent European sovereign debt crisis took even seasoned market observers by surprise.[152] **The fact is that virtually all assets can be "high-risk,"** especially if held in high concentration. In light of this economic reality, the Agencies should deem all trades to be *prima facie* "high-risk," and only allow Section 619(d) exemptions on a case-by-case basis, pursuant to a separate application by the concerned bank. Such an interpretation may be unpopular in the banking community, but the Agencies should be motivated by an objective assessment of the myriad holdings that can bring a bank to failure, and not by partisan pressure from the banking lobby.

The Proposed Rule makes insufficient use of CEO certifications as an enforcement tool. At present, CEO verification is only required within the contexts of certain prime brokerage transactions and the Volcker Rule's programmatic compliance regime. For any banking entity that relies on any exclusion from the general Volcker prohibition (e.g., market making, government securities, exempted funds, etc.), the Agencies should also require that the CEO specifically certify that the banking entity's activities do not result in a material exposure of the banking entity to high-risk assets or high-risk trading strategies, and further do not pose a threat to the financial stability of the banking entity or the United States. Although the limitations on high-risk activities are already embedded in the Rule, these provisions will actually benefit from real-world enforcement if CEOs are held personally accountable.

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[151] William Selway & Martin Z. Braun, *JPMorgan Proves Bond Deal Death in Jefferson County No Bar to New Business*, Bloomberg, Aug. 12, 2011, *available at* http://www.bloomberg.com/news/2011-08-12/jpmorgan-proves-bond-deal-death-in-jefferson-county-no-bar-to-new-business.html.

[152] *See* Amalia Estenssoro, *European Sovereign Debt Remains Largely a European Problem*, The Regional Economist (Federal Reserve Bank of St. Louis), Oct. 2010.

C. High-Risk Trading Strategies

The Proposed Rule is ineffective because it does not properly define the term "high-risk trading strategy." This term is currently defined to include "a trading strategy that would, if engaged in by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail." The Agencies have failed to specify any trading strategies that are risky *per se*. Below, we describe several trading strategies that should fall within the definition.

1. Leverage Cap on Permitted Proprietary Trading

The Agencies should ban any proprietary trade that is permitted under a Section 619(d) exclusion if that trade is conducted through leverage that exceeds 3-to-1 debt-to-equity leverage. This also means that any "covered fund" must maintain a leverage ratio of 3-to-1 or less. We recognize that a 3-to-1 cap on leverage may be more restrictive that current banking standards in various contexts. Admittedly, the Market Risk Capital Rules, the upcoming implementation of Basel III, and various broker-dealer rules all impose less exacting leverage limitations on banks for what are currently-routine banking transactions. Even so, the Section 619(d) exemptions are not meant to allow banks to carry on "business as usual," and so the "usual" leverage standards need not apply in this context.

The Agencies must remain cognizant of the fact that the Section 619(d) exemptions are only meant for the most staid, basic, "plain vanilla" proprietary trades. "[T]he intent of section 619 is to restore the purpose of the Glass-Steagall barrier" and the exemptions to the basic ban on proprietary trading are only meant for "low-risk, client-oriented financial services."[153] The imposition of a 3-to-1 leverage would comport with the legislative mandate to require that any permitted exemptions be "low-risk." In fact, *if the Agencies decline to implement this recommendation, we would challenge them to demonstrate how the absence of any explicit leverage requirement in their Proposed Rule satisfies the legislative mandate for "low-risk."*

The role that leverage played in the recent financial crisis is well understood. In April 2004, the SEC voted unanimously to permit the largest broker-dealers to increase their leverage limits up to 30-to-1 or higher.[154] That decision has been identified as a major cause of the recent "Great Recession."[155] Bear Stearns and Lehman Brothers are conspicuous for their presence on this list of the SEC's "favorite sons."

The SEC and the other Agencies have been presented with an opportunity to undo the damage of that April 2004 decision. The Volcker Rule's "high-risk trading" backstop is an opportunity for the Agencies to impose explicit leverage limits on banking entities conducting exempted proprietary trading. One commentator has even argued that the imposition of appropriate

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[153] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).
[154] *See, e.g.*, Joseph E. Stiglitz, *Capitalist Fools*, Vanity Fair, Jan. 2009, *available at* http://www.forbes.com/2009/09/25/clinton-global-initiative-personal-finance-investing-ideas-bill-clinton.html.
[155] Alan S. Blinder, *Six Errors on the Path to the Financial Crisis*, N.Y. Times, Jan. 24, 2009, *available at* http://www.nytimes.com/2009/01/25/business/economy/25view.html.

leverage ratios would obviate much of the Volcker Rule's complexity.[156] The imposition of a 3-to-1, or some other prudent leverage limit would provide the markets with definitional certainty on a significant aspect of the Volcker Rule, and would help safeguard the fiscal health of the global economy.

2. Ban on Rehypothecation

One particularly nefarious trading strategy that should be banned in connection with permitted proprietary trading is the practice of rehypothecation. Rehypothecation occurs when banks borrow from third parties using collateral that is made up of securities or other assets that have been posted as collateral by the bank's client in a separate transaction. This practice is particularly dangerous because rehypothecations can occur in chains, such that the same collateral is reused multiple times in successive borrowings. The obvious problem is that the actual assets backing the borrowings never change, whereas the overall exposure is multiplied at each successive level. The amount of potential counterparty risk in these transactions is astonishing. For instance, the last creditor in a chain of five rehypothecations is reliant on the creditworthiness of six upstream entities. Worse still, the creditor may not be aware that the posted collateral has been churned in this fashion.

While there appear to be some limits on the practice of rehypothecation in the United States, American banks have found ways to evade these restrictions through regulatory arbitrage.[157] The United Kingdom does not effectively restrain the practice, and so American banks use foreign affiliates as conduits for rehypothecation. "Even without circumventing U.S. limits on rehypothecation, the off-balance sheet treatment means that the amount of leverage (gearing) and systemic risk created in the system by rehypothecation is staggering."[158] Moreover, there is speculation that this practice may have contributed to the loss of customer funds in the recent MF Global debacle.[159]

We are especially disconcerted by the fact that a significant amount of the "liquidity" that exists in the various markets may actually be little more than a House of Cards propped up by rehypothecations. The systemic risk of rehypothecations is not fully known because "financial stability assessments typically[] do not include pledged collateral, or the associated reuse of such assets."[160] Despite being little more than a hollow subterfuge, rehypothecations appear to be widespread:

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[156] *See* William R. Hambrecht, Making the Volcker Rule Work for America: A Pragmatic Alternative to Exemptions 1 (Nov. 9, 2011), http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2011/11/Bill-Hambrecht-Volcker-Rule-Paper-11-9-11.pdf.

[157] Christopher Elias, *MF Global and the Great Wall St Re-hypothecation Scandal*, Thomas Reuters News & Insight, Dec. 7, 2011. http://newsandinsight.thomsonreuters.com/Securities/Insight/2011/12_-_December/MF_Global_and_the_great_Wall_St_re-hypothecation_scandal/.

[158] *Id.*

[159] *Id.*

[160] Manmohan Singh, Velocity of Pledged Collateral: Analysis and Implications 18 (Nov. 2011) (IMF Working Paper), http://www.imf.org/external/pubs/ft/wp/2011/wp11256.pdf.

> Engaging in hyper-hypothecation have been Goldman Sachs ($28.17 billion re-hypothecated in 2011), Canadian Imperial Bank of Commerce (re-pledged $72 billion in client assets), Royal Bank of Canada (re-pledged $53.8 billion of $126.7 billion available for re-pledging), Oppenheimer Holdings ($15.3 million), Credit Suisse (CHF 332 billion), Knight Capital Group ($1.17 billion), Interactive Brokers ($14.5 billion), Wells Fargo ($19.6 billion), JP Morgan ($546.2 billion) and Morgan Stanley ($410 billion).[161]

Defining "high-risk trading strategy" to explicitly include rehypothecation is but a necessary first step. The Agencies should give serious thought to also tightening up other relevant regulations to account for the risks posed by this practice.

3. Limits on Concentration

The Agencies should ban any proprietary trade that is permitted under a Section 619(d) exclusion if that trade would result in the banking entity owning over 50% of the market capitalization or total outstanding value of any covered financial position. Banking entities that hold inordinately large concentrations of covered financial positions face nondiversification risk with respect to those holdings. In many circumstances, unfavorable market movements can debilitate a bank if its holdings are not diversified. The risk attendant to such nondiversification is ultimately borne by depositors and taxpayers, to their detriment. For instance, in May 2008, the OCC closed ANB Financial, NA, an Arkansas bank with $2.2 billion in total assets.[162] That bank failed partly because of gross under-diversification: 85% of ANB's funding came from brokered deposits.

Additionally, a bank retaining a controlling position in the outstanding interests of a covered financial position has an incentive to "bail out" the institution issuing the covered financial position if that institution faces economic difficulty. This incentivation compounds the risk to depositors and taxpayers from the bank's over-concentrated holding.

It should be noted that banks would continue to be able to conduct permitted underwriting despite this limitation. Such underwriting could be conducted in stages or with the participation of other underwriters in a syndicate. Incidentally, this type of staggered underwriting would promote optimal price discovery for the underwritten security, as the markets would be allowed more time to properly determine equilibrium pricing.

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[161] Tyler Durden, *The Denials Begin: Interactive Brokers Is First To Claim It Has Not Engaged In Commingling Rehypothecation*, Zero Hedge, Dec. 11, 2011, http://www.zerohedge.com/news/denials-begin-interactive-brokers-first-claim-it-has-not-engaged-commingling-rehypothecation.

[162] James W. Fuchs & Timothy A. Bosch, *Why Are Banks Failing?*, Central Banker (Federal Reserve Bank of St. Louis), Fall 2009, *available at* http://www.stlouisfed.org/publications/cb/articles/?id=1667.

4. Personal Trader Liability

None of the major investment banks currently operate as partnerships, but decades ago most did utilize that structure.[163] The largest banks now operate under the public company structure, which leads to a striking moral hazard in the manner in which these banks conduct trades. Since traders have no personal liability, there is little real downside to incurring monumental losses. Provided that no fraud occurs, the worst-case scenario for a trader who loses millions or billions of dollars of depositor-backed money is the loss of a job. Given that bank bonuses have continued unabated through the crisis, one might even imagine that such a trader would enjoy a lucrative bonus before heading off to a new job at a competing bank. The problem with this limited liability trading strategy is that it encourages speculation by traders, who face no real downside risk to playing with other people's money. The Agencies can ameliorate this situation by holding traders relying on a proprietary trading exemption to be personally liable for any losses. This requirement would be consistent with the legislative mandate that Section 619(d) permitted activities be safe and customer-oriented. Two law professors have proposed this very idea as an alternative to the arcane vicissitudes of the Proposed Rule.

> We cannot bring back the old investment banking partnerships, and most investment banks will continue to be public companies. We can, however, require the most highly paid executives in these firms to personally guarantee the debts of their firms in return for their high salaries and bonuses, or pay them with stock that is subject to a cash assessment if the firm gets into trouble and becomes insolvent.[164]

This personal liability does not need to be debilitating to an individual who mistakenly incurs losses in good faith. For instance, the Agencies can require that any trader relying on a Section 619(d) maintain something akin to a capital account that tracks gains or losses on traded positions. Any gains or losses from price movements would be itemized using the capital account, and any deficiencies in that account would be deducted from the trader's salary to the extent that the salary (including bonuses and expenses paid) is above $100,000. This way, traders would still enjoy financial "incentives" to work at prestigious banks, but would personally "feel the pinch" for their losses, instead of just outsourcing the pain to their customers, depositors or the American taxpayer, as is usually done.

This system will approximate the old partnership model of investment banks. In that model, bankers knew that their money was at stake so they took less risk. Unfortunately, the corporatization of these investment partnerships has led banks to concoct ever more complex instruments and other risky machinations in the manic pursuit of profit. The Agencies should utilize personal liability or a similar strategy to address trader moral hazard. The prohibition on high-risk trading strategies is but an after-thought in the Proposed Rule's current format, and the imposition of personal liability would make it robust.

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[163] Claire A. Hill & Richard W. Painter, *Another View: A Simpler Rein Than the Volcker Rule*, Oct. 28, 2011, *available at* http://dealbook.nytimes.com/2011/10/28/another-view-a-simpler-rein-than-the-volcker-rule/.
[164] *Id.*

5. Ban on High-Frequency Trading

The Proposed Rule elides regulating one of the most precarious trading strategies that exists today: high frequency trading ("HFT"). HFT has been recognized by international securities regulators as causative of the flash crash event of May 6, 2010.[165] HFT is primarily used for proprietary trading.[166] Even if banking entities provide HFT as a client service, it has no legitimate place in a prudent, risk-averse banking entity's trading arsenal. In passing Section 619, Congress's purpose was "refocusing the bank on its credit extension function"[167] and away from financial trading machinations. By abdicating trading decisions to computer algorithms, HFT subjects markets to wild, unchecked swings in volatility.

> [T]here is the risk that rogue algorithms, i.e., algorithms that malfunction and operate in an unintended way, may trigger a chain reaction and, in turbulent market conditions, withdraw liquidity from the market or impair orderly trading. Such risk is magnified when the speed of trading takes place at fractions of a second.[168]

From a practical standpoint, regulators have a very limited ability to redress the risks borne of HFT simply because of the speed with which these transactions are completed. Thus, we recommend that the Agencies impose a resting period on any order placed by a banking entity relying on a 619(d) exemption. For instance, this resting period could forbid a banking entity from buying and subsequently selling a covered financial position within the span of 2 seconds. Any banking entity placing orders in such a short time frame is not likely to be acting on behalf of a customer's best interest, but rather its own. A resting period requirement would also limit some of the wild volatility that the markets have seen in recent months, by reducing the risk of liquidity drought. A senior executive of the Bank of England has championed such a measure:

> While raising the average bid-ask spread, [a resting period requirement] might also lower [spread] variability at times of stress. Liquidity would on average be more expensive but also more resilient.[169]

A resting period has already been considered by European regulators, and their American counterparts should do the same.

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[165] Huw Jones, *Ultra Fast Trading Needs Curbs - Global Regulators*, Jul. 7, 2011, *available at* http://uk.reuters.com/article/2011/07/07/regulation-trading-idUKN1E7661BX20110707.

[166] Technical Committee of The International Organization Of Securities Commissions (OICU-IOSCO), *CR02/11, Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency* 21 (July 2011).

[167] 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[168] *Id.* at 29.

[169] Andrew G. Haldane, Executive Director, Financial Stability, Bank of England, Address at International Economic Association Sixteenth World Congress, Beijing, China 18 (July 8, 2011), http://www.bankofengland.co.uk/publications/speeches/2011/speech509.pdf.

D. Conclusion

In summary, we recommend that the Agencies impose the following restrictions on banking entities relying on a Section 619(d) exemption. These restrictions derive their authority from the Section 619(d)(2) statutory limitations on the Section 619(d) exemptions.

1. Explicit limits on banking entity size, in order to minimize conflicts of interest;
2. Explicit limits on ownership of more than 50% of the market capitalization of a covered financial position;
3. Presumption that all assets are high-risk, which presumption may be overcome by a trade-specific application filed with the relevant Agency;
4. Explicit limits on the leverage (e.g., 3-to-1 or less) held by banks relying on a Section 619(d) exemption, in order to reduce exposure to high-risk assets;
5. Defining "risky assets" to include repurchase agreements, structured debt, assets in illiquid markets, and credit derivatives, *per se*;
6. Defining "high risk trading strategy" to include the practice of rehypothecation, *per se*, and to further require leverage caps, personal trader liability and concentration restrictions on banks relying on a Section 619(d) exemption;
7. Requiring banking entity CEOs to personally certify that the bank's activities do not result in a material exposure to high-risk assets or high-risk trading strategies, and further do not pose a threat to the financial stability of the banking entity or the United States.

The banking lobby will predictably remonstrate with an expansive interpretation of "high-risk asset" and "high-risk trading strategies" by arguing that this would reduce liquidity in the market. In assessing these remonstrations, the Agencies are reminded to abide by the legislative intent behind the Volcker Rule, which reaffirms that "it is irrelevant whether or not a firm provides market liquidity: high-risk assets and high-risk trading strategies are never permitted."[170]

[170] 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley).

VII. ECONOMIC IMPACT OF SECTION 13

In their Cost and Benefits analysis, the Agencies suffer from what Keynes referred to as the "fetish of liquidity," that most "anti-social maxim of orthodox finance."[171] Instead of considering the Volcker Rule's impact on levels of employment, output or growth in all markets, the Agencies only focus their analysis on the potential impacts of the Rule on banks. The Proposed Rule gives scant mention to the precarious nature of proprietary trading, and the danger it has posed to global market health since the winnowing away of the Glass-Steagall Act.

Indeed, in its extensive Economic Impact analysis, the NPR glosses over the anticipated benefits of the Proposed Rule, and devotes disproportionate attention to the Rule's potential costs to banking entities. The Agencies' solicitude for the profitability of banking entities is undoubtedly heart-warming and encouraging to those entities, but is considerably less encouraging from the perspective of the general public.

A. Benefits for Depositors

Many of the costs identified in the NPR occur in the form a zero-sum game, wherein a banking entity's "cost" serves as a benefit to depositors and the public in general.

The NPR notes that the Rule's restrictions may cause banking entities to lose profits from certain activities that may be on the borderline of proprietary trading. While empirical data on the point is limited, one might reasonably conclude that a positive correlation exists between risk to depositors on the one hand, and the degree to which a bank's trading activities are proprietary in nature on the other. Assuming such a correlation, a banking entity's avoidance of borderline-proprietary trading would be marginally beneficial to investors. Lost profits in such cases are not unintended "costs," but rather the crux of Section 619's intended regulatory effect. The Congressional intent behind Section 619 was to re-focus banks on customer-focused activities. An expansive interpretation of "proprietary trading" would reduce the risk of bank failure because only the most basic, customer-focused trades would make it through the Volcker Rule's gauntlet. This outcome would increase both depositor and investor confidence in banking entities, which in turn would increase real liquidity in the banking industry, and as a consequence, the overall market for credit. Increases in real liquidity would drive down real interest rates, improve consumption and help the global economy rebound from its currently depressed state.

The Economic Impact analysis is also deficient because it fails to include externalities in its discussion of the "costs" associated with bank compliance. Proprietary trading by a government-backstopped bank involves the distinct possibility of the bank needing to be bailed out, whether through depositors' funds, Federal Reserve financing, or taxpayer subsidies. The costs associated with these forms of bailout[172] must be included in the equation when considering the

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[171] John Maynard Keynes, *The General Theory of Employment, Interest and Money* 155 (1936).

[172] According to non-partisan government figures, the Federal Reserve loaned approximately $16 trillion to banks during the recent financial crisis. Phil Kuntz & Bob Ivry, *Fed Once-Secret Loan Crisis Data Compiled by*

economic impact of the Proposed Rule. To the extent that banks face costs from their compliance obligations or from lost proprietary trading profits, depositors and the public are concomitantly saved the externality costs of potential bailouts.

B. Impact on Artificial Liquidity

The NPR extensively discusses the possibility that the Proposed Rule's restrictions on proprietary trading will cause reduced liquidity and expanded credit spreads, especially in currently illiquid markets.

First and foremost, the Congressional intent behind Section 619 is to re-orient banks towards stable, customer-focused activities. This necessarily involves a shift away from trading in risky, illiquid markets. It should be noted that the Proposed Rule does not prohibit proprietary trading by all entities. Rather, it focuses solely on government-backstopped banks that have access to easy money through the Federal Reserve and customer deposits. Thus, even if "banking entities" are precluded from making illiquid markets, those markets can continue to be underwritten by conventional investment banks. Thus, any supposed impact on overall liquidity or credit spreads is questionable.

Moreover, much of the so-called "liquidity" that the banks have engineered, especially in opaque OTC markets, can be most appropriately termed "artificial liquidity." As one commentator notes, the "very belief that the proliferation of financial derivatives and securitization techniques has enhanced global liquidity has been [the] core illusion driving the sub-prime bubble in the USA."[173]

Proprietary trading involves buying and selling purely for speculative reasons that have little to do with a true assessment of a financial position's underlying value. This creates inefficiencies in the market price of such positions. True price discovery is impeded by the hyper-liquidity that is introduced by speculative proprietary traders. This hyper-liquidity, motivated by nothing more than expectations of short-term price movements, creates inefficient subsidies to buyers and sellers in the market. Depositors and the Federal Reserve unwittingly pay for these subsidies by funding banks' trading activities.

The Agencies should recognize the fact that certain markets *should* feature large credit spreads, simply because they involve truly risky products. Market makers in illiquid markets often impede natural market forces by engaging in self-interested, rent-seeking trades that create artificially narrow spreads. Thus, a reduction in proprietary trading may have the effect of increasing spreads, but that is actually a systemic benefit, not a cost, because those wider spreads will more accurately reflect the risk involved in those positions. Free of the market obfuscation created by proprietary traders, investors would be able to more efficiently allocate capital.

Bloomberg Released to Public, Bloomberg, Dec. 23, 2011, *available at* http://www.bloomberg.com/news/2011-12-23/fed-s-once-secret-data-compiled-by-bloomberg-released-to-public.html.

[173] Anastasia Nesvetailova, *Three Facets of Liquidity Illusion: Financial Innovation and the Credit Crunch*, 4 German Policy Studies 83, 94 (2008).

Hyper-liquidity may even paradoxically exacerbate market volatility. Liquidity that is propped up by banks for speculative reasons is apt to be withdrawn abruptly, when market conditions become disfavorable. This creates "liquidity black holes," which are "episodes in which the liquidity faced by a buyer or seller of a financial instrument virtually vanishes, reappearing again a few days or weeks later."[174] This disappearance and re-appearance of capital creates market volatility, which is anathema to investors and depositors alike. A stable market with moderate credit spreads would be a more salutary alternative to this scenario.

Even if illiquid markets were somehow debilitated by the Volcker Rule, there would likely be minimal impact on overall market efficiency and capital formation. **If banks are constrained in their ability to conduct legitimate market making, this will create market pressure for financial instruments to move to established exchanges and ECNs**, which empirical studies demonstrate to be relatively efficient and safe.[175] OTC markets typically feature inordinate levels of leverage that lead to non-Pareto optimal levels of default risk.[176] Indeed, as one commentator noted, "[i]t is surprising that banking authorities have not [explicitly] required banks to move [] derivatives market-making activity to a centralized exchange where transparency is enhanced and bank exposure to counterparty default risk is greatly reduced."[177] A reduction in the size of a dealer-made market would siphon investments into efficient, transparent and less-risky alternatives. The primary utility of illiquid instruments seems to be in generating lucrative fees for originators and market makers. The more "exotic" the instrument, the higher the potential for compensation for no reason other than that instrument's opacity.

C. Benefits for Banking Entities and Investors

Many of the "costs" identified in the NPR are actually benefits to banking entities, investors and depositors. In fact, the banking industry as a whole has much to gain from strong enforcement of the Proposed Rule. The premier investment bank, Goldman Sachs, has acknowledged that a harsh interpretation of the Volcker Rule will actually boost banks' profitability:

> [Goldman Sachs Group Inc. Chief Financial Officer David] Viniar said on Wednesday that if regulators impose strict trading limits, Goldman would be forced to turn over assets more quickly, and would be more hesitant to buy securities from clients that it could not immediately sell. While the executive stopped short of saying Goldman would convert to an agency trading model—which matches buyers and sellers before executing a trade—he did indicate the

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[174] Avinash Persaud, *Liquidity Black Holes: What are they and how are they Generated* (Apr. 2003), http://www.g24.org/Workshops/pers0403.pdf.

[175] *See* Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. Chi. L. Rev. 219 (2009) ("[M]any large [financial institutions] act like markets in over-the-counter interest rate, currency and credit default swaps, and other more complex derivatives, being long and short similar contracts. This large degree of derivative exposure by [financial institutions] raises some serious questions and makes it all the more important to have strong board oversight of [their] derivative risk exposure.").

[176] Viral Acharya & Alberto Bisin, Centralized versus Over-The-Counter Markets, Mar. 16, 2010, http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/acharya_bisin_otc.pdf.

[177] *Id.* at n.104.

> bank would start buying securities at lower prices and selling them at higher prices to reflect the risk of taking on trades. Those wider 'bid-ask spreads' would make trading more expensive for clients, but help boost Goldman's returns.[178]

We implore the Agencies to give Goldman what it wants, in this respect.

A microeconomic analysis also demonstrates that harsh enforcement will benefit the banking industry. The banking industry is essentially an oligopoly[179], with only a handful of major players, especially vis-à-vis trading in illiquid markets. If a bank has to divest itself of proprietary trading units or hedge funds, that only serves to dilute risk across a greater number of entities, which in turn reduces the risk that any of those entities will be considered "Too Big to Fail." As the Agencies know, many of the premier banking entities are, at present, considered to be "Too Big to Fail." This creates a moral hazard in that those institutions are incentivized to undertake catastrophic risks because they enjoy an implied promise of impunity that can take the form of government bailouts, unfettered access to the discount window, easy financing via quantitative easing and other Federal Reserve policies. Strong enforcement will put pressure on banks to increase in number and reduce in size. Under classical economic theory, the most efficient markets are typically those having an almost infinite number of competitors, while the most inefficient ones are monopolies and oligopolies.[180] A competitive market will induce banking institutions to move away from the pursuit of exotic structured transactions simply for the purpose of reaping profits for themselves, and towards the offering of customer-focused banking services with less consolidation of risk. Investors will be protected through "free market regulation," in that their interests will be promoted simply as a consequence of natural market principles. In a competitive market, banks will have strong incentives *not* to engage in risky or conflicted transactions, because doing so could lose them future business. The absence of these negative factors could serve as a competitive advantage among competing firms. Exploited customers or depositors can "vote with their feet" and move their business to smaller, less risky banks. However, when there are only a handful of "sophisticated" banks for depositors and customers to choose from, opportunities for exploitation abound. In short, market efficiency will only be promoted if the Volcker Rule is vigorously enforced, and banking services are routed to smaller competitors as a consequence.

The NPR suggests that foreign banks may gain a competitive advantage because regulations like the Volcker Rule might not exist abroad. **This reasoning is predicated on the assumption that having the ability to decimate the world financial system through risky proprietary trading is a competitive advantage; it is not.** A strong implementation of the Volcker Rule would actually create a competitive advantage for American banks. Depositors and investors can be confident that their money is safe when dealing with a well-regulated, customer-focused bank. Conversely, these parties lose confidence where banks operate in a self-interested fashion, with

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[178] Lauren Tara LaCapra, *Goldman Looks on the Bright Side of Volcker Rule*, Reuters, Feb. 8, 2012, *available at* http://www.reuters.com/article/2012/02/08/us-goldman-volcker-idUSTRE8171UE20120208.
[179] Adam Davidson, *It's the Economy: The Wild West of Finance*, N.Y. Times, Dec. 7, 2011, *available at* http://www.nytimes.com/2011/12/11/magazine/adam-davidson-wild-west-of-finance.html ("There are nearly 8,000 banks in the United States, but the top 20 control more than 90 percent of the market.").
[180] *See* K. Jothi Sivagnanam, *Business Economics* 155-56 (2010).

few regulatory checks. Thus, American banking entities can only benefit from a Volcker Rule that "has teeth."

D. Any Costs to Banking Entities are Justified

Section 619 was not passed with any additional funding allocated to the Agencies for actual enforcement. Thus, many of the costs associated with the Proposed Rule are being transferred to banking entities themselves, primarily in the form of recordkeeping and compliance obligations. This is an entirely appropriate outcome, especially given the fact that **much of the Rule's complexity is due to the banks' lobbying efforts.** The original Volcker Rule was not the 500-page behemoth it has become. The additional complexity exists as a direct consequence of the innumerable loopholes, exceptions and exemptions that the banks requested. This point was recently recognized by Representative Barney Frank, who informed the Agencies' heads during the recent House Financial Services Committee's hearing on the Volcker Rule that, "to some degree [banks] are complaining about you having accommodated them."[181] The banks now have what they wanted—an inordinately convoluted Rule—and must be required to pay for it.

Perhaps the most galling aspect of the banks' behavior in the last few years has been their inexorable insistence on issuing large-scale bonuses to their employees, despite sending the global economy into a tailspin. These banks have no compunction in borrowing 60-120% of the nation's GDP ($7.7 or $16 trillion dollars, depending on the estimate) from the Federal Reserve[182] on one hand, and contemporaneously issuing outlandish bonuses to executives, largely as rewards for highly speculative transactions.[183] If banks end up facing heightened costs from the Proposed Rule, they are free to defray such costs from compensation, and impose pay packages that are less outrageous in the extent to which they reward risky behavior. Similarly, the argument that the banks will not be able to hire and retain the best talent rings hollow when one considers the cataclysmic shift in banking that the Volcker Rule envisions. Banks must now conduct safe, "plain vanilla," customer-focused transactions. If the "best and brightest" eschew jobs that facilitate bank stability, then banks (not to mention depositors) are better off without that "talent."

The Agencies recognize that most banks have elaborate compliance structures already in place to address other rules and regulations. Even if such banks incur initial sunk costs in implementing

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[181] Mattingly & Hopkins, *supra* note 11.

[182] Bill McGuire, *Fed Loaned Banks Trillions in Bailout, Bloomberg Reports*, ABC News, Nov. 28, 2011. http://abcnews.go.com/blogs/business/2011/11/fed-gave-banks-trillions-in-bailout-bloomberg-reports/. By comparison, the entire inflation-adjusted GDP of the United States as of the last quarter was only $13.35 trillion. Timothy R. Homan, *Economy in U.S. Surpasses Pre-Recession Level After 15 Quarters*, Bloomberg Businessweek, Oct. 31, 2011, *available at* http://www.businessweek.com/news/2011-10-31/economy-in-u-s-surpasses-pre-recession-level-after-15-quarters.html. The $7.7 trillion figure may actually under-estimate the total amount loaned. A July 21, 2011 study by the Government Accountability Office indicated that the "total transaction amounts" for Federal Reserve lending actually totaled a staggering $16 trillion. U.S. Gov't Accountability Office, GAO-11-696, Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance Needed 131 (2011).

[183] Bank of America paid investment-banking employees bonuses of $4.4 billion, or an average of $400,000 per person. *See* David Mildenberg, *Bank of America Said to Pay Average Bonus of $400,000*, Bloomberg, Feb. 3, 2010, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aB9F9yg6310o.

the Proposed Rule's recordkeeping and compliance framework, over time the marginal costs associated with that framework should be minimal. Banks can utilize the "economies of scale" they already enjoy by virtue of existing compliance frameworks. In the long run, any costs placed on banking entities by a vigorously enforced Volcker Rule will pale in comparison to the benefits to be enjoyed by depositors and the general public. Indeed, the Office of the Comptroller of the Currency has estimated that, given extant compliance infrastructure, Volcker Rule record-keeping will only cost banks approximately $50 million a year. This amounts to a mere 0.3% of the estimated $15.8 billion that the top six American banks lost on proprietary trading in the recent crisis.[184]

The NPR notes that the Volcker Rule may stifle financial innovation, and cause the market for securitization and other structured products to dry up. However, the utility of these products is questionable in any case. One can hardly argue that capital markets were inefficient or illiquid before the burgeoning of esoteric financial products in the last 15 years. After all, the late 1990's saw a burst of real economic growth driven by technological innovation, which was in turn dependent on the ready availability of capital. Indeed, many well-informed people believe that securitizations and similar "innovations" have no productive value other than as a fee generation mechanism for financial companies. For example, in describing structured finance derivatives, President Bill Clinton has stated that "[w]e created all these new securities which have no value and create no jobs."[185] In his view, the markets as a whole would be better benefited by longer-term, less complex forms of capitalization.[186] Paul Volcker has expressed a similar sentiment with respect to exotic financial instruments: "I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth—one shred of evidence."[187] A similar view has also been espoused by Robert Kuttner, who has stated that:

> [i]t's time to simply abolish credit default swaps and similar exotic, impenetrable, essentially unregulated securities. They add nothing to economic efficiency, they line bankers' pockets, and they add massively to global financial risks. Swaps were only invented in the 1990s. The world got along beautifully—much better in fact—without them.[188]

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[184] *See* Editors. *Don't Give Up on the Sensible Ideas the Dodd-Frank Act Offers Banks: View*, Bloomberg View, Dec. 27, 2011, *available at* http://www.bloomberg.com/news/2011-12-28/don-t-give-up-on-the-sensible-ideas-the-dodd-frank-act-offers-banks-view.html.

[185] Robert Lenzner, *Clinton's Cure For Capitalism*, Forbes.com, Sep. 25, 2009, http://www.forbes.com/2009/09/25/clinton-global-initiative-personal-finance-investing-ideas-bill-clinton.html.

[186] *See id.*

[187] Interview with Satyajit Das, *The Financial Zoo: An Interview with Satyajit Das – Part I*, Naked Capitalism, Sep. 7, 2011, http://www.nakedcapitalism.com/2011/09/the-financial-zoo-an-interview-with-satyajit-das-%E2%80%93-part-i.html (last visited Nov. 12, 2011) ("US financial services increased its share of value added from 2% to 6.5% but is that a reflection of your financial innovation, or just a reflection of what you're paid?").

[188] Robert Kuttner, *Abolish Credit Default Swaps*, Huffington Post, http://www.huffingtonpost.com/mobileweb/2011/10/31/credit-default-swaps_n_1067152.html (last visited Nov. 11, 2011).

These viewpoints have empirical support. A comprehensive survey of empirical economic data has revealed little evidence for the existence of the financial innovation that is giddily extolled by financial institutions and their proponents.[189]

Financial innovation goes hand-in-hand with increased concentrations of risk and pricing opacity. The banking model has shifted away from "old-fashioned" prudential banking of the George Bailey variety, in favor of an "originate and distribute" model that revels in risk-taking. "[T]he banker today pays less attention to credit evaluation since the interest and principal on the loans originated will be repaid not to the bank itself, but to the final buyers of the collateralized assets."[190] From a Pareto-optimal, macroeconomic perspective, the markets would actually benefit if the Volcker Rule were to reduce "financial innovation" by government-backstopped banking entities.

Various commentators[191] have suggested that the Proposed Rule's restrictions on fund ownership would require banks to sell their assets under sub-optimal, "fire sale" conditions, especially in illiquid markets. However, these commentators overstate the Volcker Rule's impact on liquidity. For instance, junk bond trading volumes are at record levels, which has led one industry insider to opine:

> This rise in volume is a strong indication that brokerage houses were crying wolf about the reduced liquidity that was supposedly resulting from the anticipated implementation of the Volcker Rule.[192]

Moreover, the assumption behind the "fire-sale" argument seems to be that the Proposed Rule's implementation is imminent. In actuality, even after the Rule is implemented, banks can enjoy an automatic 2 year Conformance Period, followed by up to three 1 year extensions and/or a 5 year extension for illiquid funds. Allowing banks to conceivably hold assets until July 2022 is hardly indicative of a "fire sale" requirement. Indeed, most major banks have already shut down their proprietary trading desks,[193] well before the Proposed Rule has even gone into effect.

In summary, the Volcker Rule, if vigorously enforced, will re-orient banks towards conservative, customer-focused transactions. Even if major banks undergo significant costs in changing their business models to suit, those costs are required by Section 619 and are justified by the benefits to be had on a larger scale.

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[189] *See* W. Scott Frame & Lawrence J. White, *Empirical Studies of Financial Innovation: Lots of Talk, Little Action?*, 42 J. Econ. Lit. 1 (2004).

[190] Anastasia Nesvetailova. *The End Of A Great Illusion: Credit Crunch And Liquidity Meltdown* 16 (2008), http://www.diis.dk/graphics/publications/wp2008/wp2008-23_credit_crunch_and_liquidity_meltdown.pdf.

[191] *See* Dave Clarke & Joe Rauch. *Banks Seek to Avoid Volcker Rule "Fire Sale"*, Reuters. Dec. 7. 2011, *available at* http://www.reuters.com/article/2011/12/07/us-financial-regulation-volcker-idUSTRE7B60QZ20111207.

[192] Joseph Ciolli. *Junk-Bond Trading Rises to Most Since February: Credit Markets*, S.F. Chronicle. Jan. 26, 2012. *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/g/a/2012/01/26/bloomberg_articlesLYDHMY07SXKX01-LYF14.DTL&ao=all#ixzz1ktbQdhuz.

[193] *See, e.g.*, Maria Aspan, *Goldman Shutters Two Proprietary Trading Desks*, Reuters, Mar. 1, 2011, *available at* http://www.reuters.com/article/2011/03/01/goldmansachs-proptrading-idUSN0110849120110301.

VIII. CONCLUSION

Many Americans stand at the threshold of an uncertain future. The Agencies involved in the Volcker rulemaking process have an historic opportunity to redress many of the economic wrongs of the past, and create a future that privileges the interests of the many rather than the few. We ask that you vigorously implement the considerable responsibilities that have been discharged to you by Congress, remain faithful to the statute's intent and consider the comments contained in this letter.

Thank you.

Sincerely,
/s/
Occupy the SEC

Akshat Tewary
Alexis Goldstein
Corley Miller
George Bailey
Caitlin Kline
Elizabeth K. Friedrich
Eric Taylor