

Submitted on media behalf of George Michaels, CEO, G2 FinTech

February 6, 2012

Department of the Treasury Federal Deposit Insurance Corporation

Office of Domestic Finance 550 17th Street, N.W.

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Washington, D.C. 20520

Board of Governors of the Federal Reserve Office of the Comptroller of the Currency

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Washington, D.C. 20551

Commodity Futures Trading Commission Securities and Exchange Commission

1155 21st Street, N.W. 100 F Street, N.E.

Washington, D.C. 20551 Washington, D.C. 20549

Re: Comment on the proposed Volcker Rule

Dear Sir or Madam,

G2 FinTech appreciates the opportunity to provide our input on section 619 (the proposed "Volcker Rule") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund.

Executive Summary

In the context of the proposed rule, we offer the Agencies this comment on defining and creating criteria for identifying market-making versus proprietary trading activity. We submit that if firms can understand and readily identify proprietary trading activity, then they can effectively abide by the Volcker Rule and minimize banking risk, enabling banks to become more focused in their business operations. We discuss the need to develop a litmus test, which focuses on compensation/bonus pool allocations, for firms to use in order to determine and easily ascertain whether or not they are conducting market-making or proprietary trading. We explain how this test can be applied in order to facilitate the successful implementation of the Volcker Rule.

Differentiating between proprietary trading and market-making

Identifying proprietary trading versus legitimate market-making can be quite complex. There is a valid reason for market-making to remain with banks and brokerages. For example, in the case of derivatives trading, when a client wishes to place an order, there might not be an immediate, natural counterparty, nor might there be one for an extended period of time. This forces the market-maker to take a position in the derivative to facilitate the client order. These positions are both necessary and valuable because, on the whole, they help the markets operate in an orderly fashion. If everyone was forced to wait for a natural counterparty before they were allowed to trade, market swings would be greatly magnified and panics more commonplace. The problem is that these market-making positions make it incredibly difficult for an outsider to distinguish between legitimate client-related activity and proprietary trading for the firm's own profit.

The real goal of the Dodd-Frank Act and the Volcker Rule is for proprietary trading risk to be held by hedge funds. This means that both the financial institutions and the agencies that regulate them need a simple, yet effective metric to help separate market-making from proprietary trading.

To determine if the firm is primarily doing market-making or proprietary trading, instead of looking at positions, we suggest that financial institutions should look at how the bonus pool for the front office is allocated. In the world of proprietary trading, traders are compensated purely on their P&L. For a proprietary trader, customer activity is, at best, irrelevant. In the world of legitimate market-making, the compensation is based on commissions, and keeping customers happy is the trader's entire focus. Every trader knows what drives his or her bonus. If the driver is P&L, then they can be said to execute proprietary trades. If the driver is commissions, then they will generate customer flow and can be said to be market-making. You simply need to ask each trader how they get paid and you will know whether the firm is doing proprietary trading or market-making.

This is a simple, two-step process:

- (1) The sell-side will need to classify personnel as back office and front office. Then, they need to categorize all compensation paid to the front-office personnel as either commission based or P&L based.
- (2) If the amount of money that is paid based on P&L is greater than the amount of money paid based on customer flow (commissions), then you are looking at a proprietary trading operation, and the firm should be held in violation of the Volcker Rule.

With this simple process (Michaels Metric) to ascertain whether a firm is doing market-making or proprietary trading, firms and regulators will have the clarity they need to comply with the Volcker Rule.

Sincerely,
George Michaels
CEO, G2 FinTech

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