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COMMITTEES:
APPROPRIATIONS
BUDGET
ENVIRONMENT AND PUBLIC WORKS
FOREIGN RELATIONS

United States Senate

WASHINGTON, DC 20510

October 3, 2018

The Honorable Jerome H. Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

The Honorable Jelena McWilliams
Chair
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

The Honorable Joseph M. Otting
Comptroller
Office of the Comptroller of the Currency
400 7th Street SW
Washington, DC 20219

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

The Honorable J. Christopher Giancarlo
Chairman
U.S. Commodity Futures Trading Commission
1155 21st Street NW
Washington, DC 20581

Dear Chairman Powell, Chair McWilliams, Comptroller Otting, Chairman Clayton, and Chairman Giancarlo:

On May 30, 2018, your agencies issued "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds" to Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, also known as the Volcker Rule. To be clear, the proposed revisions are a naked attempt to once again allow risky trading practices at federally insured institutions while taxpayers are at risk for footing the bill for another massive bailout.

Former Senator Carl Levin and I were successfully able to include the Volcker Rule in the Dodd-Frank Act to separate traditional banking from Wall Street's reckless trading practices. Congress intended for the Volcker Rule to function as a modern-day Glass-Steagall Act, acting as a firewall to safeguard traditional loan-making and deposit-taking at banks from high-risk bets that put customers and the financial system at risk.

However, the proposed revisions do just the opposite of creating a modern-day Glass-Steagall. SEC Commissioner Kara Stein astutely summarizes the intent of regulators to unwind these

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regulatory efforts: "[T]his proposal cleverly and carefully euthanizes the Volcker Rule."[1] These proposed changes are a creative maneuver to allow Wall Street banks to evade compliance while exposing taxpayers, investors, and our capital markets to enormous risks.

The rule was finalized in 2013 and went into effect in 2015, requiring compliance by covered financial institutions. Since that time, there was only a single penalty for non-compliance of the Volcker Rule.[2] Nevertheless, numerous press reports highlight very questionable trades and investments, which seem to violate the basic intention of the rule to minimize risks at these institutions.[3] The Volcker Rule has not been adequately enforced and I question whether these proposed changes are needed.

Further, what are the justifications for these changes? The Volcker Rule requires financial institutions to report certain metrics from their trading desks so regulators can monitor trading activities, including inventory turnover and inventory aging. Yet my multiple requests for the release to the public of data, reports, and studies regulators have collected, compiled, or received regarding the Volcker Rule have essentially gone unanswered.

As former Federal Deposit Insurance Corporation Chair Sheila Bair recently wrote in *The Wall Street Journal*, "the lack of transparency makes meaningful public input in the rule-making process more difficult."[4] Without sufficient data shared with the public and Congress, it is very difficult for an accurate assessment of what changes, if any, are needed. The revisions hint at forthcoming additional changes without any being proposed which leads to further opacity. Leaving commenters without the chance to review changes begs the question as to whether revisions would violate the Administrative Procedure Act.

Additionally, the revisions to the Volcker Rule are not a singular effort to ease compliance for financial institutions. Instead, the revisions are part of holistic effort to dismantle the reforms instituted in the Dodd-Frank Act that were instituted to make the financial system more stable. Many of the critical improvements made to the regulatory system have been or are in the process of being watered down, including stress testing and capital requirements.

The proposed revisions made by the five financial regulators to the Volcker Rule could open major loopholes for the biggest banks to avoid complying with core financial protections. This comment letter considers six of the revisions.

[1] SEC Commissioner Stein's testimony on proposed revisions to the Volcker Rule, June 5, 2018, available at: https://www.sec.gov/news/public-statement/statement-stein-060518-2

[2] Ben McLannahan and Jessica Dye, "Deutsche Bank fined $156.6m over currency and Volcker violations," *Financial Times*, April 21, 2017, available at https://www.ft.com/content/7dc4e7ec-2620-11e7-8691-d5f7e0cd0a16.

[3] Justin Baer, "How One Goldman Sachs Trader Made More Than $100 Million," *The Wall Street Journal*, October 19, 2016, available at https://www.wsj.com/articles/how-one-goldman-sachs-trader-made-more-than-100-million-1476869402 and Shahien Nasiripour, Sonali Basak, and Steven Arons, "Wild Trading Day at Deutsche Bank Raises Questions on Risk," Bloomberg, June 20, 2018, available at https://www.bloomberg.com/news/articles/2018-06-20/wild-trading-day-at-deutsche-bank-raises-questions-on-u-s-risk.

[4] Sheila Bair and Gaurav Vasisht, "The Volcker Rule Needs Transparency More than 'Simplification,'" *The Wall Street Journal*, September 9, 2018, available at: https://www.wsj.com/articles/the-volcker-rule-needs-transparency-more-than-simplification-1536524547?tesla=y

1. Treatment of RENTD, "The heart of the Volcker Rule."[5]

Following the financial crisis, it became clear that Wall Street financial institutions were using client funds to make investments for their own gain, also known as proprietary trading. The Volcker Rule's purpose was to put an end to this type of reckless speculation with clients money. Under current rules, trading is permitted for market making and underwriting purposes—two client-focused activities.

Banks may not engage in the buying and selling of financial instruments beyond the reasonably expected near-term demand, or RENTD, of their clients. As highlighted in *RENTD – The heart of the Volcker Rule*, Deloitte's report on the proposed changes, "the RENTD requirement is present in the original statutory language and it plays a central role in achieving the broad regulatory objective of eliminating impermissible proprietary trading within financial institutions covered by the Volcker Rule."[6] In order to qualify for RENTD, banks demonstrate to regulators specific analyses to justify market making and underwriting activities on behalf of their clients.

However, the proposed revisions essentially drives a stake into the heart of RENTD. As drafted, banks would no longer be required to justify to regulators their activities and whether they were done in anticipation of actual client demand or their own book. Instead, banks will be able to self-regulate. After self-selecting their own internal risk limits using variables and calculations they see fit, regulators will deem banks in "compliance" if they stay within bounds of the risk limits set by their own metrics. These changes would not only make it easier for banks to evade the Volcker Rule, it would also make it harder for regulators to enforce the rebuttable presumption without demonstrable analysis. This was not the approach intended by Congress.

Americans have seen the devastation that came from basing regulation, or the lack thereof, on the incorrect free market theory espoused by former Federal Reserve Chairman Alan Greenspan. In 2008, before a House Oversight Committee, Greenspan himself admitted his free market ideology may have been flawed.[7] That is why it is all the more surprising that prudential regulators would offer these revisions to water down a critical aspect of Congress' effort to limit risk in our financial system just ten years after the Great Recession.

2. Hedging

Market events come and go, but J.P. Morgan's London Whale, or the loss of $6 billion, in 2012 stands out. At the time, the losses were chalked up to trades that hedged the bank's risks. However, a subsequent investigation by a Senate Committee found evidence to demonstrate that they were in fact proprietary positions and not legitimate hedging activities.[8]

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[5] Michael Bailey, Rajeev Trehan, and Jeremy Simon, "RENTD – The heart of the Volcker Rule," Deloitte Report, Summer 2018, available at: https://www2.deloitte.com/content/dam/Deloitte/us/Documents/risk/us-risk-rentd-heart-of-volcker-rule-summary.pdf

[6] Ibid, p. 19

[7] Brian Naylor, "Greenspan Admits Free Market Ideology Flawed," *National Public Radio*, October 24, 2008, available at: https://www.npr.org/templates/story/story.php?storyId=96070766.

[8] U.S. Senate Committee on Homeland Security and Governmental Affairs, "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses," March 15, 2013, available at:

In the 2013 final rule, banks were required to demonstrate to regulators that their risk-mitigating hedge and analysis were actually risk mitigating. The goal was to ensure banks would not use this as a loophole to get around the Volcker Rule requirements. While it only went into effect in 2015, there is little doubt that the trading of derivatives in the 2012 London Whale case would have violated the Volcker Rule.

The proposed revisions removes the requirement that banks must perform correlation analysis around their hedging activities and lowers what is considered a hedge. These changes would make it difficult for regulators to detect prohibited activity. Currently regulators are able to examine the correlation analysis and without it banks could engage in poor risk management practices that could lead to significant future losses.

Yet again, regulators are weakening the Volcker Rule in deference to banks by allowing them to determine what works best for their models without considering the risk this roll back could have on the customers of these institutions and the system as a whole. One of the regulators own analysis of the revisions agreed that weakening the hedging protections could allow some banks to engage in proprietary trading under the guise of hedging. The Securities and Exchange Commission noted that these specific revisions "may potentially increase moral hazard and conflicts of interest between banking entities and their customers."[9]

3. Liquidity Management

In the 2013 final Volcker Rule, trades executed for bona fide liquidity management purposes were carved out. Any effort to expand the carve out further is unnecessary.

That is why it strikes me as exceedingly risky for the proposed revisions to allow banks to incorporate derivatives, including foreign exchange (FX) swaps, cross-currency swaps, and forwards, under the liquidity management carve out.

The types of derivatives included in the proposed revisions to the Volcker Rule could be used in the currency markets for speculative bets under the guise of liquidity management. Currently, banks are permitted to trade these derivatives if they fall under the permitted activities. Therefore, these instruments should not be included without any clear demonstration by regulators that they are needed for liquidity management.

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https://www.hsgac.senate.gov/subcommittees/investigations/hearings/chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses.

[9] "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds." The version published by the Securities and Exchange Commission contains its analysis of the costs and benefits of the proposal, available at: https://www.sec.gov/rules/proposed/2018/bhca-3.pdf.

4. Foreign Bank Financing

No one in the United States is exempt from the law of the land, including foreign financial institutions. The U.S. operations of foreign banks were included in the Volcker Rule to create a level playing field with a single standard for all institutions operating in our well-respected market.

The 2013 final Volcker Rule regulation barred the U.S. operations of foreign banks from financing the prohibited activities of their foreign parents and other foreign affiliates. This was to ensure that the risks associated with investments in hedge funds and private equity funds conducted abroad did not wind up showing up as risks in U.S. markets.

It is not prudent to give foreign banks a green light for risky trading. The proposed revisions allows U.S. operations of foreign banks to fund otherwise prohibited activities of their parent firm abroad. This change only adds more risk to the system while creating a dual system for American banks and foreign ones.

5. Trading Account Definition

The Volcker Rule's prohibition on risky, speculative trading extends to the transactions conducted for the bank's trading account. Any transactions that occur outside of the trading account fall outside of the scope of the Volcker Rule, which is why the definition of "trading account" is crucial.

The proposed revisions to the Volcker Rule narrows the definition of trading account without any justification to demonstrate it is needed. As a result, it is expected that fewer trading desks at banks would be under active oversight by regulators. Further, regulators would be less able to restrain and prevent the reckless behavior of banks demonstrated in the lead up to the financial crisis.

6. CEO Attestation

As a matter of accountability, the Volcker Rule instituted a compliance requirement for an attestation by the Chief Executive Officer (CEO) of certain covered financial institutions. CEOs are required to provide, in writing, an annual attestation to their regulator affirming the institution has processes "to establish, maintain, enforce, review, test and modify."[10] The attestation certifies that their compliance program is in line with the Volcker Rule.

The proposed revisions does not require the CEO attestation for banks in the new limited trading category, which may include some banks that are currently subject to this sensible requirement. I was surprised that regulators chose to weaken this accountability requirement. Just like in the Sarbanes Oxley Act, signed after the Enron scandal in the early 2000s, the head of the firm who bears the responsibility should attest that their firm is complying with the law.

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[10] Federal Reserve's Frequently Asked Questions regarding the Volcker Rule, Question 7 regarding CEO Attestation, September 10, 2014, available at: https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#7.

These revisions are an unfettered effort to try to return to a time of free market ideology where banks essentially made their own rules. Yet as drafted, these proposed revisions are nothing short of watering the Volcker Rule down to render it meaningless. It is unfathomable that this close to the Great Recession regulators would propose these changes. While many Americans are still struggling to make ends meet, these mammoth financial institutions are experiencing historic profits.[11]

Maintaining a strong Volcker Rule is imperative to protecting taxpayers, investors, and the stability of our financial system. While revisions to the Volcker Rule are considered, I respectfully request you examine and take my comments into account.

Sincerely,

Jeffrey A. Merkley

Jeffrey A. Merkley

[11] Yalman Onaran, "U.S. Mega Banks Are This Close to Breaking Their Profit Record," Bloomberg Markets, 21 July 2017, https://www.bloomberg.com/news/articles/2017-07-21/bank-profits-near-pre-crisis-peak-in-u-s-despite-all-the-rules.