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Statement of the Shadow Financial Regulatory Committee on

The Volcker Rule: Market Making Exception

February 13, 2012

In November 2011, the OCC, FRB, FDIC, and SEC issued a 530 page joint proposal to implement Section 619 of the Dodd-Frank Act (the “Volcker Rule”) to bar banking entities and their affiliates from engaging in short-term proprietary trading. The Act contains exceptions for, among other things, market making-related activities. The proposed rule identifies six factors to distinguish prohibited proprietary trading activities from permitted market making-related activities, without any indication of their relative importance:

- Trading activity in which a trading unit retains risk in excess of the size and type required to provide intermediation services to customers;
- Trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues;
- Trading activity in which a trading unit: (i) generates only very small or very large amounts of revenue per unit of risk taken; (ii) does not demonstrate consistent profitability; or (iii) demonstrates high earnings volatility;
- Trading activity in which a trading unit either (i) does not transact through a trading system that interacts with orders of others or primarily with customers of the banking market making desk to provide liquidity services, or (ii) holds principal positions in excess of reasonably expected customer demands;
- Trading activity in which a trading unit routinely pays rather than earns fees, commissions, or spreads; and
- The use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.

The proposal, which requested comment on 383 questions, drew a torrent of comments that pointed out that it was enormously complex, impossibly imprecise to comply with, and would have severe adverse domestic and international consequences. These comments asserted that market making necessarily involved taking inventory positions that can be well nigh indistinguishable from proprietary positions, as the proposal itself noted in footnote 198. The Committee believes that this objection has substantial merit.

Given the considerable uncertainty in distinguishing between market making and proprietary trading, the Committee believes that the Dodd-Frank Volcker provision will impose a special burden on the supervisory process. It would be advisable to try to minimize adverse consequences from the rule's implementation by taking two steps: First, to include in the rule a presumption of validity in supervisory review of the classification of trades made by an institution in its attempt to apply the six factors. Second, to clarify the distinction from commercial banking supported by a federal safety net, all security-trading activities should be conducted in a separately capitalized subsidiary. The result would be a simpler rule that would be easier both to comply with and to enforce.