February 13, 2012

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RE: Proposed Rule to Implement Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Dear Sirs and Madams:

We write in response to the request for public comment on the proposed rule to implement the Volcker Rule, embodied in section 13 of the Bank Holding Company Act.[1]

[1] Federal Register, Vol. 76, No. 215, November 7, 2011, pp. 68846-68972.

The Volcker Rule Demands that the U.S. Financial System Be Redesigned to Serve the Real Economy

In recent years, the American middle class and its economy have been the victim of three types of abuse by the financial industry: usury, bailouts, and prolonged tolerance of debt overhangs that should be resolved to make the economy more vital. Any economy where financial intermediation becomes dominated by these three abuses cannot succeed in the long run. Rather than providing the real economy with the services and resources it needs to grow, an economy with a financial industry dominated by the three abuses becomes the master of the real economy, in fact draining it of resources.

We have long been arguing for a more functional system, one which does more of what a financial system is suppose to do – supporting the real economy that creates jobs, increases productivity, and raises living standards – and less of what it should not do – extracting resources from the economy and reducing wealth.[2]

The Volcker Rule, as crafted by Senators Jeff Merkley and Carl Levin, is one of the more potent forces available for achieving precisely that goal: forcing a redesign of the capital markets activities of our financial system so that they support the real economy and minimizing the risk of future financial crashes. In short, it demands sweeping and healthy change in the way our nation's largest financial firms do business.

The Volcker Rule was drafted with an eye towards – and must be considered from – a systemic viewpoint. At its most basic, it forces a strong separation between hedge fund-like activities that deploy high risk in search of high reward, and depository lending banks, which should take modest risks to extend credit to families, small business, and the real economy generally.

The construct of the Volcker Rule statute mandates a *fundamental reconsideration* of activities in trading accounts and off-balance sheet funds of bank holding companies, the loci of losses in recent crashes, and the heart of the complex trading activities that served only the bonuses of the bankers, put taxpayers at risk, and did not serve the real economy. The Volcker Rule forces the simplification of and reduction of the trading account and off-balance sheet structures, ensuring that those activities are not embedding abusive, dangerous activities, but are contained in their risk profile and serve client needs.

We have examined the thrust of the arguments of those arguing against the principles of the Volcker Rule, and we find them unpersuasive, self-serving, and to a large extent, refuted by what has happened in recent years. In particular, some have argued that the Volcker Rule approach is too complex and will limit liquidity. These arguments are a distraction. The Volcker Rule *will* reduce trading by banks and quite likely trading overall. But quite frankly, this is precisely what the real economy needs. For instance, the so-called liquidity from flash trading

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[2] See JOSEPH STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY (2010); Robert Johnson, *Introduction: Make Markets Be Markets*, in Robert Johnson, Erica Payne, eds, MAKE MARKETS BE MARKETS, ROOSEVELT INSTITUTE (2010)

disappeared precisely when it was needed most. Recent scholarship has shown that the current financial system, with its dramatic increase in trading, is actually less efficient than that of 1950 or even 1980.[3] Trading has brought record compensation for Wall Street traders, but the real economy of the last thirty years has not been similarly invigorated. Rather, it has seen real wages decline, jobs move overseas, and the middle class shrink. Trading volume should not be mistaken for efficient capital markets or productive investments.

To the extent the Volcker Rule is too complex, that is at best a reflection of the incredible complexity that banking itself has created, and at worst a reflection of the proposed rule's timidity: it attempts to protect the complexity of the status quo and implement a law that directs a reduction of trading by banks without reducing trading by banks or trading overall. These contradictions must be rejected. For the U.S. to rebuild a healthy financial system – one where savings go to productive investments, and the returns go back the investors – the Volcker Rule's mandate to reduce bank involvement in complex trading activities must be implemented.

Naturally, banks are resistant to these demands because they have taken refuge in complexity to extract massive margins and fees that generate bonuses, while avoiding the harsh sunlight of competition and the risk-reducing incentives of the threat of failure. A short history lesson will make this clear. Decimalization of brokerage commissions in the 1990's cut into brokerage profits, while the rise of derivatives and complex instruments undermined profits from transparent markets. The fall of Glass-Steagall and the deregulation of derivatives meant securities firms had to compete against banking firms, which had the ability to deploy large balance sheets and did. At the same time, hedge funds like Long-Term Capital Management (LTCM) proved the immense profitability of complex trading strategies, at least during calm years. As these trends came together, the banking and securities industries – in many cases, now effectively one – sought out complexity, opacity, and leverage as a means to avoid true competition and protect profitability, and as a way to extract outsize profits during normal years, stuffing risk into ever larger "fat tails."

In just a few years, the finance industry replaced client-service and the extension of liquidity and credit with leveraged proprietary positions in complex algorithmic trading strategies and complex structured products. This search for "alpha" profits drove booms and busts and reduced returns to investors, incrementally in the normal years and spectacularly in the bust years. In the normal years, every dollar made when a proprietary trading operation front-runs a customer order or otherwise surfs on the waves of the orders generated by their customers was a dollar lost to pensioners, mutual funds, and other savers and investors. And in the bust years, only the firms plugged into the bailout windows could avoid the massive losses inflicted on everyone else. Complexity protects the powerful, while everyone else is left in the dust.

A general principal of all businesses is that they would like to be subsidized by the public; and a general principle of economics is that such subsidies distort the market place. Any risk of a government bailout, hidden or transparent, is a subsidy, and these subsidies have been deeply

[3] Thomas Philippon, *Has the U.S. Finance Industry Become Less Efficient?*, Working Paper, Nov. 2011.

imbedded in our financial system, different parts of which have been repeatedly bailed out. Any behaviors that give rise to lack of full transparency impede the working of the market place, give rise to rents, and distort the economy. The combination of lack of transparency and risk, associated with over the counter derivatives, was predicted to be lethal, and was.

There are costs of any set of regulations, but there are costs of not regulating. As Lord Adair Turner, Chairman of the UK regulatory authority pointed out, the losses from inadequate regulation are orders of magnitude greater than the losses associated with regulations.[4]

We have seen no argument from the opponents of these regulatory changes that refutes this analysis. And indeed, these regulations hold the promise of making financial markets act more like markets – and thus, not only of protecting the Treasury from another bailout, but of enhancing the efficiency of our financial system and its ability to serve the rest of the economy.

In short, the Volcker Rule's success should be measured by how well it can reduce the complexity and opacity in the banking system, as well as how well it can replace the false liquidity of booms and busts with real liquidity that facilitates investing by clients and growth in the real economy.

The proposed rule does not yet achieve that goal. Nor is this failure excusable as an exercise in regulatory discretion. The statute and every piece of legislative history connect to it clearly shows that the law is systemic in orientation and demands that the regulators reduce this self-serving complexity and replace it with real economy-serving simplicity. Simply take the statute.By defining proprietary trading as *any* proprietary position in the trading book, and then letting back in only certain permitted activities, subject to limits that the activity not give rise to a conflict of interest or high risk, the statute is directing the regulators to permit at banks only the most basic capital markets services that are designed to support the real economy.[5] Everything else should be excised from the core of the financial system. If the periphery wants to engage in it, let them do so without the core capital provided by FDIC insured deposits (and without the implicitly insured money-market mutual fund savings, as well – hence the Volcker Rule's coverage of systemically significant non-bank financial companies). This may not be the simplicity that industry appears to be begging for, but it is the simplicity that the law requires and the proposed rule does *not* provide.

Specifically, to implement the structure noted above, a final rule should provide *clear, narrow* safe harbors for *simple* activities that serve real economy customers: underwriting for basic stocks and bonds that raise capital for real economy firms, *genuine* market-making in plain vanilla corporate and government bonds, and hedging that *reduces* exposure to volatility and others risk that may arise in providing the market-making and other services noted above.

[4] See Lord Adair Turner, "Reforming Finance: Are We Being Radical Enough?", 2011 Clare Distinguished Lecture in Economics and Public Policy, February 18, 2011; Lord Adair Turner, "After the Crises: Assessing the Costs and Benefits of Financial Liberalisation," Fourteenth C. D. Deshmukh Memorial Lecture, February 15, 2010.
[5] Bank Holding Company Act, Section 13(a),(d).

Complex structured products are "high risk assets" that should be eliminated.[6] Complex trading strategies are "high risk trading strategies" that should be eliminated. And, if absolute simplicity is truly what the industry demands, then the regulator should provide that: the Volcker Rule statute, in its authority to subject permitted activities to "*any* limitations or restrictions that the [regulators] may determine," gives regulators the authority to *entirely* eliminate all securities and derivatives trading by the banking industry.[7] Industry cannot have its cake and eat it too.

Capitalism Requires Failure, and Failure Requires Transparency: The Volcker Rule Demands this Be Provided

Accounting Transparency and Prompt Corrective Action. In recent years, regulators have increasingly relied on the regulation of capital as the basis for their regulation and supervision of the largest financial institutions. This effort depends on a meaningful measurement of a firm's capital, which in turn is only as good as a firm's understanding and valuation of the assets it is holding. We have seen over time that even the firms with the smartest risk managers and high-powered computer models have gotten valuations of assets – and capital – very wrong. It happened in LTCM. It happened in the valuation of subprime derivative securities during the recent financial crisis. It is likely to happen again. Capital charges are one tool, but they are only one piece of the puzzle. They must be complemented by activity restrictions that simplify bank activities and support honest valuations of assets and capital.

In recent years, banking regulations have permitted, even encouraged, banks to use complex modeling devices to evaluate the capital they hold against positions. Not only has this in general permitted banks to lower the amount of equity they hold to withstand losses, but it also has permitted, even encouraged, banks to structure ever more highly complex derivatives and securities, sometimes for clients but more frequently with an eye towards giving themselves whatever risk exposure they wanted for their own proprietary positions.

These bespoke assets are highly detrimental to bank balance sheets because they are valued through complex computer modeling, and occasionally by a trade with or estimate by a friendly trader at a competitor firm engaged in the same type of asset myth-making. Mark to model is not a sound valuation method. Models assume infinite liquidity that does not exist. This opacity creates a mark-to-myth nature for bank balance sheets, which means bank capital – that remainder after liabilities are reduced from assets – is also a work of fiction. Moreover, as "trading book" assets, they have tended to benefit from significantly lower capital charges than comparably illiquid assets in the "banking book." Mark-to-myth begs the question whether holding such an asset can be said to be trading at all, much less whether the asset can be valued like a liquid asset in a way that is meaningful.

This tendency towards mark-to-myth valuations is further exacerbated by compensation structures that reward the bankers based on higher accountancy valuations. These structures actually double down on risk because in addition to overstating capital, they also encourage

[6] Bank Holding Company Act, Section 13(d)(2)(A)(ii).
[7] Bank Holding Company Act, Section 13(d)(1) (introductory paragraph).

traders to "shift the distribution," pushing more risk into a fat tail which is practically backed only by a conjectural call option on the American taxpayers. That call was exercised in 2008. Its risk-adjusted price made it a very profitable hedge, for industry – and very unprofitable for taxpayers.

This is a driver of systemic risk because without clarity with regards to capital, it is impossible to determine when a firm is near failure. This means "prompt corrective action" cannot be effected, and resolution simply becomes an exercise in the application of political power – a dangerous position in a world post-*Citizens United*, or any world, for that matter.

While Basel III rules look to improve elements of bank capital, they do not go far enough in dealing with this highly profitable but highly dangerous driver of systemic risk. Only the Volcker Rule, and potentially the upcoming Basel review of the trading book, demands this problem be addressed. What is required is separation of the safety net from the proprietary trading of financial institutions. U.S. taxpayers should not be subsidizing traders' bonuses.

Specifically, the market-making permitted activity must be limited only to assets that can be reliably valued in, at a minimum, a moderately liquid market evidenced by trading within a reasonable period (for example, within a week). This would mean that a bank must mark an asset through a real transaction (and not simply with interdealer trades) on a regular basis. For assets that cannot be so reliably valued, in particular bespoke derivatives, structured products, and other assets that, as the proposed rule puts it in footnote 149, "trade only by appointment," if at all, they should not be permitted under market-making.[8] As such, to the extent that a banking organization is permitted to write them, which is highly questionable from a supervisory and macroprudential perspective, they should be treated as an illiquid bespoke loan, with the full capital charges that would arise under the banking book for such a risky asset.

Some may argue that this type of limitation will reduce liquidity to the small and mid-sized corporate bond market. Properly constructed, rules governing market-making should not materially impact the ability of these issuers to raise capital. They are likely, however, and should, significantly impact the "markets" which are dominated by bespoke derivatives and complex structured products, which add little to the real economy, and are frequently simply disguised leveraged proprietary bets.

<u>The Volcker Rule Is Structured to Be A Firewall to Stop Risk Propagation Across the System</u>

Crowded Trades and Systemic Resilience. The second major issue that the Volcker Rule addresses is the risk of our largest banking organizations driving – and getting caught in – the booms and busts that have become so prevalent in financial markets recently.

[8] Federal Register, Vol. 76, No. 215, November 7, 2011, p. 68871.

Again, the problem arises from trading based on market appreciation, and the ensuing search for "alpha" returns. Because traders get paid when valuations go up, they are incentivized to put their trades into the middle of crowded markets, and even to drive markets in the directions of their trade. The problem is that these crowded trades propagate and exacerbate any problems in those markets. Because correlations increase in a crisis, problems are further magnified and transmitted across asset classes. As positions are impaired at firms, firesales and runs result – up and until bailouts are deployed to stop them, as the Federal Reserve recognized in 1998 with the collapse and bailout of LTCM.[9]

In short, our largest banks should be separated from these markets, and the risk propagation they cause, by a strong firewall. A strong firewall will significantly add to the resiliency of the financial system as a whole.

Specifically, to effect this firewall, firms need to be only engaged in true market-making or risk-mitigating hedging trades, and not disguised proprietary trading. Certainly, the difference between them is one of degree, not kind, but as the degree differences become large, they become starkly differences in kind. Accordingly, the way to effect the firewall is to erect a narrow, clearly delineated permitted space, on a lowest-level, desk-by-desk basis, within which can occur safe, real-economy serving market-making in basic products and risk-reducing (for both system and firm) hedging. Beyond that simple space should be assumed to be suspect proprietary trading.

The permitted space for market-making should be established through bright line rules establishing a weekly balance sheet within which market-making and hedging (on a desk-by-desk basis) can occur. As long as the trader, over the time period, has stayed within the balance sheet, he or she should be presumed – absent other evidence, such as high volatility or low revenue-to-risk metrics (again, bright lines are needed, but regulators should have discretion to go beyond them), that the trader is market-making.[10] This balance sheet amount should be small, as market-making should not require significant amounts of inventory. Inventory levels must be rational based on two types of measurement: the risk must be proportionate to the market-making business that it supports; and the amount should be consistent with turnover in the underlying market-making business.

This presumption permits a trader to hold a position overnight or, for certain of the less liquid corporate bonds, even over several nights. However, firms should enforce an average over a time period, which means that on other days the trader will need to close the book out flat – as

[9] Indeed, the purposed reason the New York Federal Reserve Bank led the bailout of LTCM was not because of any desire to save LTCM but because all the other major Wall Street banks had crowded trades in the same direction as LTCM, and any collapse by LTCM would decimate the asset markets and thus the capital positions of the firms.
[10] Market-making is a reliably profitable business, and can return a Sharpe Ratio of 3, but won't return the outsized profits of that proprietary trading can deliver, which have low Sharpe Rations of 1 or less, (high risk-to-revenue) and rely on traders shifting the distribution curve. Sharpe Ratios are less reliable in less liquid markets (another indication that such business may not be trading activities at all).

many are already required to do at well managed firms. The goal of this structure is to eliminate the capacity for the trader to effect large carry-trade positions.

Special attention should be paid to options trading and other derivatives. Even if traded on an exchange in a liquid market, these assets are highly volatile and difficult if not impossible to effectively hedge except through a completely matched position. In these cases, options and similar derivatives may need to be required to be sold only as riskless principal trades "on behalf of customers," or significantly limited through capital charges.

It is essential that this permitted space be gauged at the lowest-level trading desk because hedging can only be reliably measured on an asset class basis. As the statute requires, hedges should be "specific" to risks and "specific" to positions, and not on a portfolio basis. This is because hedging by specific positions limits cross-market correlation, which can break down in times of stress.

Monitoring these activities is essential, and regulators and supervisors today have an enormous need for real-time, reliable data. To establish the bright lines needed to set forth the permitted space for genuine market-making and risk-mitigating hedging, regulators should investigate data from a range of firms, including over time periods prior to the financial crisis, as well as at present. Moreover, regulators can give confidence to market participants that they have not been captured by industry by making the on-going data from the firms (the metrics) available to investors through public disclosure, perhaps on a delayed basis.

Critically, this permitted space should be provided for plain vanilla products that raise capital or provide intermediation services that benefit the real economy, and not for complex assets or complex trading strategies that simply extract resources from it. This may require regulators defining the type of simple stocks and bonds that firms can hold. This is not beyond the tradition of U.S. banking regulation, as for many years, banks were limited only to the most basic debt assets, and broker-dealers were practically limited to only fairly liquid securities, debt and equity. The regulatory trends loosening those rules, including the expansion of the use of derivatives and the "hedges" that can go to back them, must be reversed. A final rule should include characteristics for simple, plain vanilla assets that banks can trade.

Nor should trading activities be unlimited. The range of relative value and complex arbitrage strategies that have arisen in recent years do not belong in our largest, most critical financial firms. Expanding the volume of trading should not be seen, in and of itself, as providing a sufficient enough service. The lessons of the Flash Crash should not be as quickly forgotten as the lessons of LTCM were. A final rule should ensure that these trading strategies not be conducted.

Finally, compensation is a powerful tool that must be fully utilized to support the firewall between complex, high risk activities and simple, lower risk market-making. Rational actors go into finance because of the powerful incentives it provides. Regulators must ensure that incentives are fully aligned in favor of the limited market-making and risk-mitigating hedging space set forth above, and not designed to incent higher-risk proprietary trading. Indeed, we encourage you to look specifically at the hedge fund industry. Because hedge funds take large risks, but are small enough and do fail, their managers must put in place procedures to limit risks.

Two suggestions may be valuable here. First, traders should be paid based on the results of the positions they put on and should only be paid once all positions are unwound. This will discourage them from carrying inventory and encourage them to get out of positions. It will also limit the practice of collecting bonuses based on the price appreciation of assets in the short-term, when the long-term performance of the asset is highly questionable. Second, compensation should be risk-adjusted and/or based on performance relative to an outside object indicator – for example, an index. Market-makers should not outperform the index – there is no "alpha" in market-making – and market-making should not be highly volatile. Incentives should reward risk-minimization and fidelity to the goal of market-making and risk-reducing hedging.

Regulators Should Use Apply the Volcker Rule Globally Until Foreign Regulators Agree to a Coordinated Cross-Border Resolution Regime

International Coordination. Much media attention has come to the purported concern by foreign ministries of finance and foreign banking regulators regarding the potential extraterritorial application of the Volcker Rule. First, it should be noted that the principal foreign alternative to the U.S. for banking and securities, namely the United Kingdom, is on track to implement a variation of the Volcker Rule in what is known as the Vickers Commission's ring-fencing proposal. More importantly, however, the question of extraterritorial application should be addressed head on.

Specifically, the Volcker Rule should be applied globally to all firms until a coordinated cross-border resolution regime is fully established.

The Volcker Rule is one of the only available tools for limiting the risk of financial crises. Assuming it is implemented correctly – as outlined above – the Volcker Rule has the potential to increase transparent accounting needed for meaningful prompt corrective action, while limiting the risks of contagion from crowded trades and firesales. Until a credible cross-border resolution regime is established,[11] all global financial institutions are exposed to these risks, and the preventative tools of the Volcker Rule should be applied to them. Once such a resolution regime is established internationally, then may it be more appropriate to let each country establish the protections (such as significantly higher capital charges) – or provide for permanent bailouts – that it so chooses.

Should progress on such a resolution regime be forthcoming, regulators may consider restoring traditional territorial application of the rule, on a country by country basis. Moreover, even once

[11] For more on designing a successful cross-border resolution regime, see Robert Johnson, *Credible Resolution: What It Takes To End Too Big To Fail*, in Robert Johnson, Erica Payne, eds, MAKE MARKETS BE MARKETS, ROOSEVELT INSTITUTE (2010).

a global resolution agreement is put in place, application of the "limitations on permitted activities" should still be utilized to require maintenance of global minimum standards established by the Basel Committee.

Conclusion: Remember the Goal

In conclusion, we urge the regulators to remember their mandate. They must implement the law in a manner that achieves the purposes of the law. In the case of the Dodd-Frank Act's rules on proprietary trading and relationships with hedge funds, that purpose is clear: to limit the risk of previously uncontrolled trading activities that brought such destruction and mayhem to the economy, to restore banking organizations to the function of supporting the real economy, and to limit the abuses of bailouts that offends the American people and undermines faith in governance and the capitalist enterprise that has made this country great.

Sincerely,

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