December 22, 2011

TO:

Federal Deposit Insurance Corporation 550 17th Street, NW Washington, DC 20429	Securities and Exchange Commission 100 F Street, NE Washington, DC 20549
Board of the Governors of the Federal Reserve System 20th Street & Constitution Avenue, NW Washington, DC 20551	Department of the Treasury, Office of the Comptroller of the Currency 250 E Street, SW Washington, DC 20219

FROM: Anthony Flynn, Jr., Koral Fusselman

RE: Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds

Dear Sirs/Madams,

We are third-year law students at Washington & Lee University School of Law. As part of our third-year curriculum, we have elected to take a four-credit Banking Law Practicum. In this practicum, we worked in a simulated General Counsel's office of a fictitious mid-sized, regional bank. Our curriculum required us to develop an implementation plan for the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

In developing our implementation plan, we grew concerned with the workability of the definition of "market-making activities" as presented in the proposed rule implementing the Volcker Rule, which is covered in Section 619 of the Dodd-Frank Act. Market-making activities allow banks to help their clients participate in traditional financial deals by providing access to secondary markets. Market-making is not just a tool for complex financial schemes, but is used by banking clients across the spectrum, from Wall Street to "Main Street" clients such as retirement funds or 401(k) plans. For example, market-making can help a mid-sized airline lock in oil prices on the futures market or can allow a pension fund or University endowment to develop their financial footprint and serve their respective constituents.

Due to the centrality of market-making activities to the work of regional banks, we believe it is crucial that an appropriate, broad, and clear definition be adopted. It is certainly not the objective of the Dodd-Frank Act to decrease the liquidity necessary to provide "Main Street" clients access to the financial markets and we are concerned a narrow or unclear definition may produce this undesired result.

We would like to thank the Securities and Exchange Commission ("SEC"), the Office of the Comptroller of Currency ("OCC"), the Board of Governors of the Federal Reserve System

("Board"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively the "Agencies") for their diligent work in developing appropriate rules to safeguard the stability of our economy while also providing framework for a functioning and thriving marketplace. We hope the Agencies find this comment to be informative, helpful, and persuasive in their deliberations.

I. Dodd-Frank and Market-Making Activities

A. Limiting the Scope: What Are Market-Making Activities?

The Volcker Rule aims to prohibit deposit banks from both proprietary trading and investing in or controlling private equity or hedge funds, but provides an exemption for, among other things, market-making activities. Market-making activities are trades that banks use to provide liquidity to the market. Banks sometimes create markets to give their clients an appropriate forum for particular types of secondary investments. Traditional investments—such as buying common stock on an exchange—provides capital to corporations but ties up the capital of the investors in the process. Secondary markets work in parallel to the primary markets.

Secondary markets are vital to efficient investing because these secondary markets are very liquid. Instead of tying a client's money up in corporate equity, they allow clients to take short positions that can be turned into cash very quickly. Or they allow clients to take longer positions that can be more carefully hedged then direct investment in a corporation. This allows clients to maintain access to necessary cash reserves while still providing the client with opportunities to expand their bottom line through market interaction. Access to secondary markets gives clients additional breathing room to invest in primary markets because their primary market positions will be hedged in the secondary markets. Greater investment in primary markets has the benefit of promoting corporate growth, which is imperative to growing the economy back to pre-recession levels.

We believe the Volcker Rule should be carefully tailored to target only risky proprietary trading. These trades operate for the sole purpose of generating profit for the banking institution and thereby have the potential for creating bank profit at the expense of a client's position in the marketplace. True proprietary trading is not driven by arbitrage or trade execution at the request of a client, but rather by an institution's own bottom line.

The market-making discussed in this comment takes three basic forms: proprietary trading, principal transactions, and agency trading. The complex financial instruments beyond these three forms are covered by other regulations and statutes and will not be discussed in this comment. We will, however, provide a brief summary of the aforementioned three types of trading activities that fall under the market-making heading.

Principal transactions occur when a bank commits capital to the market to provide liquidity at the request of a client for the client's profit. Typically, but not always, these transactions occur on a fee basis, which allow the bank to make a profit while not risking its larger capital stores (which could include depositor's money). However, these principal transactions can involve some proprietary risk due to the use of the bank's own account to be the opposite side of a client's transaction. For example, if a client wishes to place a bet on the movements of a commodities market, but there is no one to bet against, banks can properly make the market by being the opposite side of that bet. This situation is typical and appropriate market-making, but still involves the potential for some risk by the bank if there is some dramatic change in the market. Banks can use some hedging instruments to limit their risk, but it would be rare for a bank to be able to completely eliminate the risk involved in engaging in a principal transaction.

Agency transactions do not involve a bank's own account, thereby eliminating a substantial amount of risk to the bank. However, these agency transactions do not provide the flexibility to the client that principal transactions do because the client is limited by his or her own capital limits. Principal transactions have the potential to give the client access to a marketplace they would otherwise be too financially constrained to join because the bank can use its own capital to provide the client access to the market. There is a lower risk to the bank in an agency transaction when the bank only recoups a fee from the client. Agency transactions place the bank in much the same position as a stockbroker.

Proprietary trading is clearly at the heart of Section 619. Proprietary trading is when a bank uses its own cash stores to make a trade, solely for the bank’s own profit. The danger here is if the bank makes a risky trade there is potential for client or depositor money to be lost. Essentially, in true proprietary trading, the bank stands to make all of the profit but clients stand to lose money. Unfortunately, while the proposed rule targets proprietary trading it envelops principal transactions as well. This broad reach is somewhat justified because principal transactions have the potential to create a conflict of interest between the bank and the client. However, as discussed below, the current rule does not do enough to draw a bright line between allowed and prohibited forms of principal transactions as executed as part of market-making activities.

B. Legislative Intent and Goals for the Volcker Rule

Paul Volcker, the Chairman of the President’s Economic Recovery Advisory Board and former Chairman of the Federal Reserve, conceived of the Volcker Rule. In his original proposal, Volcker aimed to encourage traditional commercial banking activities, including commercial, consumer, and residential loans, while discouraging more speculative activities. Volcker argued that while there is a public policy rationale for supporting essential banking functions with taxpayer dollars there is no similar rationale for using those funds to support "proprietary and speculative activities." These speculative activities—hedge funds, private equity funds, and trading activities unrelated to customer needs—should be forced to "stand on their own" without the assistance of taxpayer dollars to rescue them should these speculative activities prove to be a misplaced bet.

In his testimony before Congress, Chairman Volcker discussed the necessary elements of the definition implementing the Volcker Rule; the definition must be simultaneously restrictive to the supervising agencies and yet broad enough to prevent banks from circumventing the law’s intent. Volcker believes that most bankers are aware of the implications and meaning of "proprietary trading," but proposes that supervisory agencies focus their analysis on "volume relative to customer relationships and particularly [focus on the] relative volatility of gains and losses." In instances where examiners discover "substantially large gains and losses," Volcker proposed "substantially raised capital requirements" to offset the degree of risk associated with those transactions. Chairman Volcker knew that what needed to be curbed is the bank taking on risk with client's or depositor's money in a way that is not in the client's benefit. Separating the bank's risk from the client's assets ensured that a failure of the bank would not ripple through the economic system. Unfortunately, the current proposed definition of market-making does not allow for many of the traditional forms of market-making which benefit the client and the bank.

Inherent in bank involvement in these proprietary trading activities are conflicts of interest. Chairman Volcker noted that "when a bank itself is a 'customer'—that is when it is trading for its own account—it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interest of an unrelated commercial customer of the bank." Volcker argued that banks, through proprietary trading, "should not be able to profit from knowledge of customer trades." Volcker envisioned the rule as aiming to "curb[] the proprietary interests of commercial banks" while "appropriately defining the business of commercial banks." The proposed version of the rule does not define the prohibited market-making under a conflict of interest standard; this is not in line with the legislative history of Section 619.

The Volcker Rule initially targeted volatile and high-risk activities. Proprietary trading activities that solely benefit participating banks are, by definition, not undertaken for the benefit of customers or clients. In its purest form, the rule would force firms to "choose between owning an insured depository institution and engaging in proprietary trading, hedge fund, or private equity activities." According to Chairman Volcker, "basic payment systems . . . , safe and liquid depository facilities . . . , credit for individuals, governments and businesses . . . , underwriting of corporate and government securities with related market-making, brokerage accounts for individuals and businesses . . . , investment management and investment advisory services . . . , trust and estate planning and administration, and custody and safekeeping arrangements for securities and valuables" would all remain un-touched by the Volcker Rule. These traditional banking activities would be protected under the Rule and should be sufficient to maintain and "provide a base for strong, competitive, and profitable commercial banking."

We certainly believe that volatile and high-risk activities should be quartered off into entities separate from the bank and insulated from corporate veil piercing. This separation decreases the potential for one bad bet to cause a ripple affect that could bring down the market as a whole, because depositor and client money would be safe from the bank's own trades. However, this separation of the riskier, more speculative proprietary trading activities is certainly within Chairman Volcker's vision for the rule, he did not aim to minimize or limit market-making activities. In fact, Chairman Volcker explicitly proposed including market-making activities in the list of allowable "traditional" banking activities. Accordingly, the regulation implementing the Volcker Rule must carefully delineate and allow banks to conduct the market-making activities necessary to provide liquidity to their customers.

The legislative history is rife with calls for a bright line delineating what is and is not acceptable under the Volcker Rule. A bright line definition will give banks notice as to what they may do and achieve the balance of protecting the integrity of the financial system without slowing economic recovery. An overly complex and muddled definition of market-making will not fulfill the goals clearly indicated by the legislative history.

II. Finding a Workable Definition of "Market-Making Activities"

A. Concerns with the Proposed Rule

Our primary concern is that the proposed rule lacks a bright-line definition that would simultaneously provide predictability to covered entities and also prevent banks from evading the intent of the legislation. Additionally, a clear definition would provide clear guidance to the agencies' examiners and enforcement officers. While under the proposed rule a covered entity cannot trade for profit for the institution's own "trading book," an entity may do so as part of a "market-making activity." This definition of market-making leaves a vague and ambiguous guideline and will lead entities to go down one of two routes. Banks may either pull back from creating access to secondary markets for their clients or they may try to force the prohibited hedging and proprietary trading activities into a permitted market-making construct to avoid the reach of the Rule. Grey areas of the law invite the regulated entities to discover, or create, loopholes. If banks stop helping clients reach secondary markets then this would decrease liquidity in the market and frustrate efforts to restore national financial stability. Legal loopholes created by an overly complex or vague rule would defeat the purpose of Section 619, potentially setting the stage for another systemic meltdown as we saw in 2008.

Basing the definition of market-making activities on whether a bank is using its own "trading book" would unnecessarily and inappropriately preclude many principal transactions. When clients lack necessary capital, banks will sometimes use their own stores, and thus their own trading books, to provide capital liquidity and give clients access to secondary markets. This is one of the forms of principal transactions discussed above. The start of the process necessitates use of the bank's own "trading book," for otherwise the client would not be able to access the market. The bank providing money "up front" is a typical market-making activity. If the rule bases the definition of market-making on whether the bank is using its own "trading book," then some legitimate forms of market-making may be prohibited.

Some commentators have suggested that the difference between a proprietary trade and a market-making activity is that in a proprietary trade the bank stands to make independent profit from the creation, success, or failure of the market. We agree with this statement of purpose and believe it is a more appropriate benchmark for the Volcker Rule. (See II.B below). However, the proposed rule goes in a different direction, utilizing seven principles to define market-making. These principles look at the form and structure of the trade more than the potential for conflicts of interest.

Some of the seven criteria will be effective in achieving the goals of Section 619. The first criterion, "[e]stablishment of internal compliance program," keeps a strong focus on the bank's own workings and allow banks to self-monitor. This is an appropriate, cost-effective, and efficient way to encourage market-making while ensuring activities do not cross the line into the sort of proprietary trading targeted by the statute. With an internal compliance program, a bank will be able to enforce standards, written policies and procedures, and a structure by which to gather information for federal reporting requirements.

The third criterion is also appropriate as it focuses on the goals of the client. True market-making should be client-focused, creating space and opportunity for a client who wishes to enter secondary markets. The fourth criterion is also appropriate: a basic registration requirement that allows the regulating federal agencies to know whom to monitor.

The second and seventh criteria are vague and overly broad, and the fourth and fifth criteria unnecessarily limit the kinds of relationships and agreements banks can enter into with their clients. Each of these criteria pairings are addressed in turn below.

The second and seventh criteria define specific kinds of activities that can be considered market-making as opposed to the prohibited "proprietary trading." The exercise in analysis required by the second and seventh criteria is extraordinarily complex, for as the proposed rule itself says, "The precise nature of market maker's activities often varies depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location…." This highlights the difficulty in defining market-making by looking at individual trades. For a trade that may be considered market-making at one time may at a different moment be considered proprietary, depending on the evolution of complex markets. Factors as arbitrary as the geographic location of the trade subject may determine whether a trade is considered market-making or proprietary under the second and seventh criteria.

The second criterion takes up three pages, and the seventh criteria incorporates a full appendix, Appendix C, that is nine pages long. These pages list dozens of different considerations and factors that "may" (or, we assume in the natural converse, may not) be taken into consideration by a regulatory authority when determining, post hoc, whether a trade was bona fide market-making or was proprietary. This gives very little notice to banks as to what kinds of trades they may provide for their clients.

This complex hodgepodge of factors stands in stark contrast to the clarity of the first, third and fourth criteria, which lay down specific markers. As we discussed in the legislative history section of this comment, having clear markers for what is or is not allowed is vital to the healthy functioning of banking entities and the markets as a whole. Banks need to be on notice as to what they can or cannot provide to their clients and regulators need easy to follow and easy to implement guidelines to target activities that violate Section 619.

Fuzzy definitions may defeat the goals of the rule in one of two ways. One, it may cause banks to be overly cautious in their market-making activities, stymieing the goals of their clients and slowing economic recovery. Or two, it may spur clever lawyers to find loopholes in the language of the rule, thus defeating the purpose of Section 619. The less clear the rule is, the more room there is for "creative" interpretation. While ferreting out legal loopholes makes for many billable hours, the final rule should provide clear definitions that prevent legal acrobatics and lengthy court battles with federal regulatory agencies.

The fifth and sixth criteria seek to define proprietary trading based on the manner in which a bank makes a profit from creating the market opportunity. These two criteria attempt to determine if there is a conflict of interest between the client's goals and the bank's goals. We believe this is an appropriate measure for market-making. (See II.B below.) However, these two criteria manage to be at the same time overly broad and constricted by vague language.

The fifth criterion requires that a bank assisting a client with market-making "generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions it holds in trading accounts or the hedging of such positions." The sixth criterion prohibits compensation based in a way that "encourage[s] or reward[s] proprietary risk trading" for persons performing the market-making activities.

As written, these rules constrict the ability of banks to work with their clients to create a variety of market-making strategies. As long as there is full disclosure, banks and clients should be able to make a variety of agreements in regards to compensation and revenue. As discussed below, the final rule should contain criteria similar to the fifth and sixth criteria proposed, but should limit the criteria to situations where the revenue or compensation arrangement creates a conflict of interest between the bank and the client.

B. A New Definition

We would like to suggest some elements that may be useful in developing a new definition of market-making. As our analysis above in II.A indicates, we believe that much of the current definition is very workable. However, the lengthy list of factors contained in criteria two and seven prevent easy implementation by banks and inhibits adequate regulation by supervisory agencies.

We believe two factors are vital for the spirit of Section 619 to be implemented without overburdening banks or preventing banks from helping their clients access secondary markets. First, we believe that it is vital that the rule be a bright line definition of what is acceptable and what is not acceptable. Second, we believe the rule must target the bank's relationship with its client and prevent the inherent conflicts of interest in proprietary trading.

The second and seventh criteria are simply too long and unworkable for banks to be on any reasonable notice as to what is or is not acceptable market-making. Both contain long lists of acceptable forms of trades, but many trades do not fall neatly into categories. The proposed criteria leave a lot of room for gray area. This gray area allows for evasion of the legislator's intent for Section 619 and prevents banks seeking compliance to easily ascertain implementation steps.

We believe these laundry lists are unnecessary. We suggest the second criterion be combined with the seventh criterion and that these combined criteria be moved into the Appendix. We also believe a strong caveat should be included in this newly created Appendix. This caveat should state: "This section indicates what the regulatory agencies believe would be permissible under the rule. This list is not exhaustive and serves to illustrate, rather than to restrict, appropriate market-making activities."

The detail provided by the second and seventh criterion is suitable to educate through example, but is a poor guide for giving banks a bright line definition of market-making. Including our recommended caveat would ensure the rule is not mudded with vagary, but would still include the important guideposts provided by the second and seventh criteria.

Other sections of the Dodd-Frank Act and of this proposed rule address conflicts of interest. We believe those same principles should be applied to the market-making exception. There are many different types of trades that can occur at the request of a client to further the client's legitimate financial interests. Some of these legitimate trades may require the bank to engage in its own proprietary trade to assist the client's goals. If the bank and the client believe that this is in the full financial interest of the client, the bank should be allowed to make the trade.

We proposed the inclusion of additional conflict of interest language to the fifth and sixth criteria. In certain situations, banks and clients may see fit to work out alternative fee arrangements or, if the client is particularly low on capital, they may wish for the bank to take on additional risk for a bigger pay off later. The danger inherent in these trades occurs when the bank takes positions contrary to the interests of their client. We therefor suggest amending the first sentence of criteria five and six as follows:

> *Fifth criterion: Under the proposed rule, the market making-related activities of the banking entity must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions it holds in trading accounts or the hedging of such positions, <u>unless the client gives reasonable informed consent and the generating of revenues does not create a conflict-of-interest, material or otherwise, between the banking entity's financial, corporate, or business goals and the client's financial, corporate, or business goals.</u>*
>
> *Sixth criterion: Under the proposed rule, the compensation arrangement of persons performing market making-related activities at the banking entity must be designed not to encourage or reward proprietary risk-taking, <u>unless the client gives reasonable informed consent and the compensation agreement does not create a conflict-of-interest, material or otherwise, between the banking entity's financial, corporate, or business goals and the client's financial, corporate, or business goals.</u>*

This will achieve the goals of the legislation by still limiting how much the banks can proprietarily trade, but still allows for clients and banks to reach reasonable agreements in furtherance of the client's interest. There is sufficient flexibility for giving clients access to markets, but also protecting the client's interests and safeguarding the integrity of the system.

III. Conclusion

The Dodd-Frank Act and the Volcker Rule represent significant steps to regulate and direct the financial markets towards recovery. Paul Volcker hoped to eliminate public financial support for banks engaging in speculative and risky behaviors. Traditional banking activities ought to enjoy the protections afforded by taxpayer bailouts, but speculative proprietary trading activities ought not to be supported when these risky bets do not pay off. By separating these proprietary trading activities from the activities more traditionally associated with banking would serve to remove this public financial support (e.g. federal deposit insurance and government regulations) from these proprietary trades through the removal of these activities from banking institutions enjoying these public benefits.

The Volcker Rule aims to force banks to make a choice— traditional banking activities, including payment systems, depository facilities, provision of credit, and underwriting activities, or the more risky proprietary trading activities undertaken for financial benefit to the bank. These proprietary activities are conducted on a bank's own trading account and often put the bank at odds with their own customers. These conflicts of interest are inherent to proprietary trading activities.

We propose amending the current proposed regulation in two ways—first, by modifying the text of criteria two and seven and second, by including additional conflict of interest language to criteria five and six. The second and seventh criteria should be combined into a single Appendix. This Appendix would serve to illustrate, as opposed to overly restrict, appropriate market-making activities. This would provide a more workable regulation and would eliminate the gray area we believe is inherent to the current proposal.

We further propose adding conflict of interest language to criteria five and six. This language would allow for greater flexibility when implementing the Volcker Rule. We foresee situations in which clients may desire alternative fee arrangements or seek to utilize the greater resources of the bank's own trading account when investing. This conflict of interest language would allow for a client's informed consent to partially waive the otherwise blanket prohibition on proprietary trading.

In conclusion, we strongly encourage the Agencies to consider our proposals in their implementation of the Volcker Rule. We appreciate the opportunity to present our concerns and ideas. Thank you.

Sincerely,

Anthony Flynn, Jr. & Koral Fusselman
/s/