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April 19, 2012

Mr. David A. Stawick
Secretary of the Commission
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, D.C. 20581

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Re: RIN #3038-AD05, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds

Dear Mr. Stawick:

The undersigned are a group comprised by an associate professor and six upper class students at the Hofstra University Maurice A. Deane School of Law ("The Group"). Collectively, the Group has long followed and researched the remedies debated since the onset of the Financial Crisis in 2008. [1] We thus appreciate the opportunity to Comment on this issue of great moment for both regulators and the regulated alike.

This Comment Letter represents our collective efforts at evaluating the CFTC proposal referenced above[2]. The Comment Letter is divided into two parts: 1) comments on the proposed

[1] The Group includes a Professor who served as a regulator for over 10 years and who has taught *Securities Regulation* every year since 2000, and law students who have since 2009 studied, litigated, and authored articles on the law governing financial services. Specifically, three of the students in the groups are pursuing joint JD/MBA degrees. Several of the students are published authors, and nearly all of the students have interned/externed with a securities arbitration clinic, or securities regulators at the State/SRO level. All views expressed herein are purely personal to the authors.

[2] The CFTC Proposal ("Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," 76 FR 68846, (Nov. 7, 2011)("the Proposal") adopts the joint language previously adopted by the Securities and Exchange Commission ("SEC") and other agencies. *See* 76 FR 68944-68967 for the Joint Rule text adopted by the Board of Governors of the Federal Reserve System ("the Board"), the Office of the Comptroller of the Currency ("OCC"), the Federal deposit Insurance Corporation ("FDIC"), and the SEC. In short, the CFTC implements, for purposes of CFTC jurisdiction, the much publicized "Volcker Rule" called for by Section 619 ("Section 619") of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Pub.L. 111-203 (2010)("Dodd-Frank").

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final proprietary trading limitations, and 2) comments on the proposed limitations of investment in private equity enterprises.

As a preamble, the Group wishes to express two global thoughts:

i. *The nation's economic challenges occasioned by Wall Street practices are not over.*

Remarkably, some newspaper commentary from the spring of last year triumphantly declared the nation's recession to be over; concurrently, publicly available data on the repayment of "TARP" (*i.e.*, initial Bailout) monies continue to suggest that a "reset button" has been successfully pushed.

The Group feels strongly that such forgetfulness of the lingering damages occasioned by market excesses in recent years augurs only more collective setback. On a national level, the depressed housing market, the continued trading in exotic derivatives, the unfaltering downward trends in employment, and even the shockingly low interest rates paid on retail bank account deposits all speak to a crisis that has yet to abate. Stated more directly, the efforts by forces both governmental and private alike – while perhaps necessary – did not completely succeed, as the bank failures and mortgage defaults have simply hot halted, and the taxpayer monies extended via TARP simply did not come back at par.[3]

ii. *Stronger (and more pointed medicine) may still be required.*

Concomitantly, the Group is somewhat concerned that stronger action did not result from the shattering disclosures of 2008. More meaningful net capital requirements at the banking level, stronger circuit breakers at the nation's stock exchanges, and vastly increased staffing levels at the SEC and CFTC all might have succeeded in both improving financial regulation and investor morale. While Section 619's isolation and limitation of distinct business lines hints at a return to the cautious days preceding Gramm-Leach-Bliley, the fact remains that a completed and implemented Volcker Rule arguably remains a relatively small victory for those favoring more regulation of American markets.

Nonetheless, the Group feels that the Volcker Rule should proceed toward implementation. Concurrently, the Group would hope that alarms sounded in recent months by both government entities confessing missed deadlines and Wall Street lobbyists sounding practiced refrains sounding in "complexity" do not work to forestall implementation of final rules at or near the July 2012 deadline called for by the Dodd-Frank Act. To assist with the weighty efforts being undertaken by various government agencies charged with implementing the Volcker Rule, the Group hereby offers its Comments on five of the more salient points raised by the Proposal.

[3] *See* "A.I.G. Shares Fall Amid Treasury Sale," **The New York Times** (March 8, 2012).

I. Definitional challenges

With the implementation of the Dodd-Frank come a few new terms that require clarification. The most prominent term that we held worthy of notable attention was the definition of a "trading account". A trading account is defined by the Proposal "as any account used for acquiring or taking positions in securities." It is further noted that a firm makes positions in a trading account when there is intent to sell so as to profit from price fluctuations in the near term.

We agree that CFTC determination of a trading account is difficult to implement since a governing body cannot readily determine intent of a party entering into a position. However, the presently proposed definition perhaps creates some difficulties in both its interpretation and its proper execution. To wit, the three prongs noted above successfully define what is classified as a trading account; nevertheless a rebuttable presumption is afforded to rebuff institutional arrangements from being classified as such.

Without a governing body to unilaterally determine the principal basis for a firm entering into a position, proper regulation of the risk occasioned by banking activities remains a challenge. Further, it may be difficult to determine when a position is taken on solely for liquidity or for other purposes. One could justifiably question whether a position entered into for liquidity purposes can act as a pure hedge on positions in other investments. To that end, it may be both more just and expedient for the present rulemaking to simply adopt existing definitions of "proprietary account" as defined by the stock exchanges in the context of audit trail rules.[4] Simply put, if such rules – which ensure the integrity of prices and quotes relied upon worldwide – can be enabled by written definition of evasive market concepts, then it would seem that meaningful definitions within the proposed limitations on proprietary trading are likewise within reach.

Separately, the Group respectfully suggests that the CFTC must determine the appropriate authority to perform the independent testing of the financial institutions trading activities. The process of such identification should be similar to the approach implemented by the Sarbanes Oxley Act, an effective response to the accounting scandals (mainly the Enron debacle) in the early 2000's. If the independent sources are effectively kept separate, the monitoring of accounts will meet the goal of restricting prohibited trading activity. The absence of such demarcation may lead to great variance among internal risk tolerance throughout the financial industry.

II. The Registration Matrix

The Group is also concerned with the piecemeal nature of the presently proposed "provisional registration." One benefit of provisional registration is that it will allow Swap

[4] *See, e.g.,* New York Stock Exchange Rule 7410(p) ("...The funds used by a Proprietary Trading firm must be exclusively firm funds and all trading must be the firm's accounts..."). *See also* NYSE Rule 95.10 (permitting Floor members to exercise discretion when liquidating positions as part of "bona fide arbitrage").

Dealers ("SD") and Major Swap Participants ("MSP") to slowly integrate under the new legislation. Secondly, this form of registration will allow the National Futures Association ("NFA") to sort through the registration materials much more closely to ensure compliance instead of reviewing all documents in one submission date. The Group also agrees with the most recent changes to the registration process such as designating the filing date as the date of provisional registration as opposed to the date of the NFA's review and approval. This recent revision will allow business operations to continue without delay during the interim of the NFA's review of registration documents.

Notwithstanding these positive benefits, the Group is concerned that the negative implications of this approach may outweigh the advantages. As the Proposal currently stands, the registration schedule is somewhat complicated. Instead of proffering a few registration deadlines, the schedule appears to be more of a matrix in which prerequisites and final requirements are intermittently dispersed. For some regulations, the deadlines have been set up in such a way that it will lead to certain deadlines occurring every two weeks over a span of six months. As for other regulations, the deadline dates are as of yet determined. Due to this hybrid approach, as well as the complex nature of deadlines, SDs and MSPs will have to continuously sort through many legislative guidelines to ensure that all regulations are completed in timely fashion.

The Group thus proposes that the CFTC publish a more unified deadline schedule. It is respectfully urged that the presently proposed deadlines be consolidated into fewer submission dates. This will ensure adequate compliance as well as alleviate the burden on the NFA when reviewing the registration materials.

III. Proprietary Trading v. Market Making

The Group is also concerned with the Proposal's possible inspiring of market confusion over what constitutes "proprietary trading," which is prohibited, and what constitutes "market making," which is exempted. The proposed regulation does provide six key principles for distinguishing these activities: (1) risk management, (2) source of revenues, (3) revenues relative to risk, (4) customer-facing activity, (5) compensation incentives, and (6) payment of fees, commissions, and spreads. While the Group recognizes that these standards may lack the certainty of bright line rules, we believe that even broader standards are necessary to effectuate the intent of the Rule and accommodate the dynamic demands of an evolving marketplace.

The Group notes that standards governing and defining market making have already been implemented in the securities markets by administrative agencies and self-regulating organizations. Accordingly, regulators already have significant experience in determining what activities fall within the bounds of acceptable market making.[5] Rules implementing the Volcker

[5] *See, e.g.,* Rule 103 of Regulation M (exempting passive market making). The Group also notes that SEC Regulation SHO contained a "market making exemption" until its repeal in 2008.

Rule should utilize these existing and effective standards. This approach will avoid creating the regulatory uncertainty many have feared.

Concomitantly, in adopting existing definitions (and thus avoiding the "bad press" highlighting potential regulatory uncertainty), particular aspects of market making and proprietary trading should be narrowly defined. The Group believes that regulations can clearly define limits for revenues relative to risk, customer-facing activities, and the frequency of trading. First, a bright line threshold can be set so that risks will not be retained in excess of the size and type required for market making. Second, the definition of market making can and should reflect its focus on customer demands. Thus, the percentage of trades a particular trading desk makes with other securities dealers as opposed to clients should be given definitive boundaries. Finally, establishing position limits and limits on the period that securities may be held will provide clarity in differentiating between market making and proprietary trading. By providing these specific guidelines, banks will gain a better understanding of the Rule.

Without providing concrete guidance for banks by both adopting broad-based standards and, where appropriate, narrowly defining rules, the Volcker Rule could inhibit legitimate activities. Alternatively, completely novel standards could hinder the prohibition on proprietary trading through a bank's willingness to continue the practice under the guise of market making. A mixture of new, bright line rules and established standards would provide the best solution, thus emboldening the Volker Rule to affect its intended (and salutary) purpose.

IV. Prohibitions on Private Equity Sponsorship and Funding

The Group feels troubled by the Volcker Rule's prohibitions on private equity sponsorship and funding by banking entities. The dual 3% limits that will be imposed on banking entities by the Volcker Rule will significantly decrease liquidity in the private equity market, thus limiting the ability of firms to raise funds and pursue the purchase of companies that are troubled or have unrealized potential. Such purchases often result in a net positive for the U.S. economy.

Banks are currently active participants in private equity, both in the investment in private equity funds and in lending the monies required for a firm to conduct a leveraged buyout. Over the last decade, private equity firms have invested over $1.6 trillion into 15,200 companies in the U.S. Moreover, private equity firms have invested roughly $8.6 billion into bankrupt companies since the start of the recent financial crisis. Should banks be prohibited from actively participating in the private equity market, we will likely see a significant flight of private equity firms to other nations. This would unnecessarily and collaterally inhibit vital forces in the U.S. economy. In sum, the presence of private equity in the U.S. economy is valuable, necessary, and worth maintaining.

The ultimate goal of the Volcker Rule is to stem the imposition of risk on depositors and taxpayers by banking entities. By attempting to treat one excess (*i.e.,* a concentration of assets at regulated entities), the proposed Volcker Rule will unsettle revenue streams in the United States financial system by imposing an unqualified limitation that would be equally, if not more, detrimental to their stability and growth. It is respectfully submitted that a preferable alternative to the presently proposed restrictions on Private Equity would be the imposition of more flexible limits on private equity investment and sponsorship by banks. While there are inherent risks in allowing banking entities to invest in Private Equity funds, these activities did not play a sufficiently discernible role in the recent financial crisis to justify the extreme restrictions proposed by the de minimis exceptions as presently proposed. Additionally, the excesses at times occasioned by investments in particularized vehicles can perhaps best be met through strong but pointed focus upon incentives and their detection.

V. International Implications of the Volcker Rule

The Group is also concerned by the possible international ramifications of the Volcker Rule as currently drafted. We recognize that modern trading centers are inherently interconnected and global in scale. Accordingly, any effort to regulate American markets must be conscious of the effect of domestic regulations on international markets and entities. To that end, U.S. regulators should ensure that rules and regulations promote fair and open markets and avoid protectionism. Concurrently, it is imperative that U.S. regulators maintain their role as leaders in financial regulation in order to ensure the stable and efficient operation of U.S. markets. Therefore, we believe that the international implications of the Volker Rule, while requiring redress, do not preclude implementation of the rule.

Some have voiced concern that the Volcker Rule will significantly damage U. S. companies' ability to remain competitive because it applies differently to U.S. and foreign banking institutions. This is because the ban on proprietary trading restricts U.S. banking entities' global operations, whereas the ban only restricts foreign banking entities' U. S. operations. We recognize the importance of maintaining the competitiveness of American markets. We do not believe that prudent market regulation should embrace a regulatory "race to the bottom" that would weaken U. S. markets and expose them to the same frailties that contributed to the financial crisis of 2008. Instead, U. S. regulators should continue to lead the global regulatory community by enacting rules and regulations that ensure that U. S. markets are the safest and soundest in the world. We believe the Volcker Rule is a step in the right direction and that foreign regulators will, in time, recognize the necessity of their own ban on proprietary trading.

Accordingly, to best serve the dual goals that 1) American regulation stand at the forefront of global responses to the crisis, while 2) giving credence to the concern that the Volcker Rule potentially threatens the liquidity of foreign sovereign debt markets, the Group believes that the proposal's exception for trading in U. S. sovereign debt should be extended to include any nation of similar strength and stability to the U. S. To frame the exception in terms of national identity poses an unnecessary risk of provoking a protectionist backlash from foreign markets. By framing the sovereign debt exception in terms of a threshold of acceptable risk, such an international backlash could be avoided without materially increasing the level of risk posed to U. S. markets. To be sure, the nation's securities and commodities laws, which for decades have proven to be the standard for the world's emulators, are capable of such codified respect for worthy foreign markets.

Conclusion

The Group reiterates its hope that the Volcker Rule be finalized in conformance with the deadline set by the Dodd-Frank Act, passed nearly two years ago. In short, vagaries attending the adoption of pivotal terms (and their implementation) can be assuaged through the efforts of ~~regulators who have been charged with updating and enforcing regulations for decades.~~ The matrix governing effective dates for registration should be simplified and its requirements made more uniform. Separately, the 3% limits to be implemented on private equity investments may be too singular in effect to warrant inclusion. Finally, the Group is confident that crafters of the final rules called for by Section 619 can concurrently advance the nation's model body of regulation in a way that does not signal political isolation to nations whose aid may still be enlisted in fashioning responses to the persisting worldwide economic crisis.

We thank the Commodity Futures Trading Commission for the opportunity to share the thoughts included herein.

Sincerely,

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cc: Ms. Elizabeth M. Murphy, Secretary
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