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WASHINGTON, DC 20510

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VIA ELECTRONIC SUBMISSION

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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 Ladies and Gentlemen:

The purpose of this letter is to offer our views regarding the proposed rule to implement the prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds.[1] These provisions, often called the "Volcker Rule,"[2] are contained in Section 13 of the Bank Holding Company Act of 1956, which we authored (the "Merkley-Levin Provisions").[3]

The need for this provision is well established. In the years leading up to the 2008 financial crisis, we had a culture where regulators – and legislators – rolled back protections that had shored up our financial system for 70 years. In the aftermath of the financial crisis, the Senate Permanent Subcommittee on Investigations spent two years looking at the causes of the collapse, and the world learned how this poorly regulated system broke down. Banks and other lenders made bad mortgage loans. Credit rating agencies allowed those lenders and investment banks to package and sell those bad loans as triple-A-rated securities. Toxic securities saturated the financial markets and contaminated investor holdings throughout the world. Financial firms made large, leveraged bets on it all – bets that brought big profits and big bonuses on the way up, but spectacular losses and bailouts on the way down. In some cases, firms even sold their own customers products designed to fail and bet against them.[4] While regulators saw many of the problems, they did little to stop them.

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[1] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011)(hereinafter, the "Proposed Rule").

[2] For the purposes of this letter, we will use the terms "Merkley-Levin Provisions" and the "Volcker Rule" interchangeably, as the prohibitions and restrictions laid out in the Merkley-Levin Provisions embody the concept commonly referred to as the "Volcker Rule," after former Federal Reserve Chairman Paul Volcker, who was a strong proponent.

[3] Section 13 was added to the Bank Holding Company Act of 1956 by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203 (the "Dodd-Frank Act").

[4] For a fuller discussion, *See* Sen. Jeff Merkley and Sen. Carl Levin, *The Dodd-Frank Act Restrictions On Proprietary Trading And Conflicts Of Interest: New Tools To Address Evolving Threats*, 48 HARV. J. ON LEG. 515 (2011); 156 Cong. Rec. S5894-99 (daily ed. July 15, 2010) (statements of Senators Merkley and Levin); "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," Report and Appendix printed in connection with a series of hearings on "Wall Street and the Financial Crisis," before the U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 112-675, Volume 5, (April 13, 2011)(hereinafter "PSI Report"). President Obama recently summarized the financial crisis as follows: "Mortgages sold to people who couldn't afford them, or even sometimes understand them. Banks and investors allowed to keep packaging the risk and selling it off. Huge bets – and huge bonuses – made with other peoples' money on the line. Regulators who were supposed to warn us about the dangers of this, but looked the other way or didn't have the authority to look at all." He continued, "new rules of the road [were put in] that refocus the financial sector on what should be their core purpose: getting capital to the entrepreneurs with the best ideas, and financing millions of families who want to buy a home or send their kids to college." He highlighted that the new law "ban[s] banks from making risky bets with their customers' deposits" and that "unless you're a financial institution whose business model is built on breaking the law, cheating consumers and making risky bets that could damage the entire economy, you should have nothing to fear from the new rules." Hon. Barack Obama, Remarks by the President on the Economy (Dec. 6, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/12/06/remarks-president-economy-osawatomie-kansas. Felix Rohatyn, a well-known financial advisor, had this comment: "We must follow the advice of Paul Volcker and return to many of the principles of the Glass-Steagall Act to rein in rampant speculation. We must direct capital into productive uses, into businesses that manufacture and produce. And we must deal with the inequalities of lavish paydays for the few in an era of 10 percent unemployment." Felix Rohatyn, DEALINGS 109-159 (2010).

As we all know, in 2008, the mortgage market came crashing down, with devastating effects on housing, the banking system, and financial markets worldwide. Even a series of massive bailouts were not able to prevent monumental economic consequences: $17 trillion in lost wealth, continued high unemployment nationwide, and one in four of America's mortgages still underwater three years after the crisis. The magnitude of the U.S. national debt and the ongoing instability in European sovereign debt markets today are in many ways direct aftershocks of the same financial crisis.

These outcomes are proof that allowing the financial system to regulate itself is a failed experiment, and more must be done to safeguard our banks and financial systems.

Congress determined that one important step toward putting the guardrails back on the financial sector is to limit proprietary trading, high risk activities, and conflicts of interest by banks.[5] These guardrails are intended to take a systemic perspective and limit the risks, particularly market risk, that banks and systemically significant non-bank financial companies take. That is why President Obama, Chairman Volcker, five former Treasury Secretaries (of both political parties),[6] Nobel Prize winning economists,[7] community bankers,[8] institutional investors,[9] and other industry leaders[10] supported our efforts to include the Merkley-Levin Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). As regulators, you are now tasked with faithfully implementing the law.[11]

This letter is intended to provide you with detailed comments on the Proposed Rule, and is intended to supplement our previous communications to you.

I. Background and General Approach

As a starting point, we think the Proposed Rule is simply too tepid. In adopting the Merkley-Levin Provisions, Congress sought to fundamentally change the financial system of this country

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[5] For the purposes of this letter, the term "banks" is, unless otherwise specified, intended to include all "banking entities," as that term is defined by Section 13(h)(1) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*).

[6] W. Michael Blumenthal, Nicholas Brady, Paul O'Neill, George Shultz & John Snow, Letter to the Editor, *Congress Should Implement the Volcker Rule for Banks*, WALL ST. J., Feb. 22, 2010.

[7] Press Release, Office of Sen. Jeff Merkley, Merkley and Levin Introduce Legislation to Restrict Banks and the Largest Financial Institutions from Making High-Risk Bets (Mar. 10, 2010), *available at* http://merkley.senate.gov/newsroom/press/release/?id=8e6cb736-80c6-4d18-8834-5d7d05e4501a (letters on file).

[8] Letter from Steve Verdier, Executive Vice President of the Independent Community Bankers of America to Senator Jeff Merkley and Carl Levin (Mar. 10, 2010)("I wish to express strong support for legislation ... to prohibit any bank to engage in proprietary trading ... or to invest in or sponsor a hedge fund or private equity fund.")(letter on file).

[9] *See* Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 1-27 (Jul. 2009), *available at* http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf; *see also* Letter from Jeff Mahoney, General Counsel of the Council of Institutional Investors, to Senators Jeff Merkley and Carl Levin (Apr. 26, 2010)(letter on file).

[10] *See, e.g.*, 156 CONG. REC. S2691 (daily ed. Apr. 27, 2010) (citing an April 23, 2010 Letter from John Reed, Former Chairman and CEO, Citigroup, to Senators Jeff Merkley and Carl Levin).

[11] The authors wish to acknowledge the staffs of the SEC, CFTC, Federal Reserve, FDIC, OCC, and the Treasury Department for their hard work and dedication in preparing the Proposed Rule.

by restoring and modernizing safeguards that, for decades, protected the country from the types of financial abuses that caused the 2008 financial crisis.[12] Congress also sought to impose explicit prohibitions on the conflicts of interest and risks that helped exacerbate that crisis. The Proposed Rule does not fulfill the law's promise. Instead, the Proposed Rule seems focused on minimizing its own potential impact. It engages in contortions that appear aimed at trying to restrict banks' trading without impacting the volume of banks' overall trading in the markets. That is not an objective of the Merkley-Levin Provisions.

One key objective of the Merkley-Levin Provisions is to stop proprietary trading and relationships with private funds by our banks. That objective necessarily means less trading by them.[13] And while stopping proprietary trading and private fund investments by banks[14] may temporarily impact some markets, we believe—and Congress determined—that the benefits of a safer financial system outweigh those potential impacts. Indeed, nowhere in the text of the statute nor in the legislative history of the provision is there any direction to regulators that the plain meaning of the statute should be ignored because of the potential impact it might have on the volume of trading in any given market. To the contrary, we and others intended for the Merkley-Levin Provisions to be a modern version of the Glass-Steagall Act.[15]

The law's directive is simple: stop proprietary trading and relationships with private funds, and ensure that any permitted activities do not give rise to the risks or conflicts of interest that undermined our financial system. Achieving those objectives will require increased data collection and reporting, increased supervision, and substantive restrictions on some activities.

As we detail below, the final rule needs to accept the statutory mandate restricting bank activities, and ensure that permitted activities are low risk, conflict-free, and subject to appropriate safeguards and supervisory oversight. More specifically with regard to a number of provisions, the final rule needs to draw brighter lines, remove unnecessary complexities, and enable cost-effective, consistent enforcement.

This letter offers detailed comments and recommendations on a number of the provisions in the Proposed Rule. As an overview, we offer the following observations.

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[12] The Glass-Steagall Act restricted proprietary trading by federally insured banks for more than sixty years. Banking Act of 1933, Pub. L. 73-66, 48 Stat. 162. Those restrictions were removed by the Financial Services Modernization Act of 1999. Financial Services Modernization Act of 1999, Pub. L. 106-102, 113 Stat. 1338 (Gramm-Leach Bliley Act).

[13] Any reduction in trading by U.S. banks is likely to be made up by other non-banking entities entering the market. After all, U.S. financial markets became the envy of the world during the more than six decades during which the Glass-Steagall Act was in effect, while banks were generally prohibited from proprietary trading. Further, some studies suggest that some of the trading volume today actually increases market inefficiencies. *See, e.g.*, Thomas Philippon, *Has the U.S. Finance Industry Become Less Efficient*, (Nov. 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1972808.

[14] We note that the Proposed Rule does not address the analogous restrictions for non-bank financial companies supervised by the Board. 76 Fed. Reg. 68846, 68847-48.

[15] 156 Cong. Rec. S5894, S5894 (daily ed. July 15, 2010) (statement of Senator Merkley) ("The 'Volcker Rule,' which Senator Levin and I drafted and have championed in the Senate, and which is embodied by Section 619, embraces the spirit of the Glass-Steagall Act's separation of 'commercial' from 'investment' banking by restoring a protective barrier around our critical financial infrastructure.").

1. **Focus on the Economics.** If a bank is exposed to market risk for any significant period of time, then it is engaged in proprietary trading. Proprietary trading can occur in many ways – for example, when a securitization underwriting desk goes from the "moving business" to the "storage business."[16] While there may be many business units that engage in some form of proprietary trading, and the specifics of those trades may vary significantly across different business units, the economics is often the same. If a bank is making money through the appreciation or depreciation in the value of an asset, then it's engaged in proprietary trading. Similarly, if a bank is taking an interest in a fund itself, or an economic equivalent of the fund, both are forms of proprietary trading. Focusing on the underlying economics means the Proposed Rule can eliminate many of the newly-proposed exceptions and loopholes, including the blanket exemption for repurchase agreements, allowance of hedging on a portfolio basis, or the proposal to allow firms to "hedge" how much they may have to compensate their fund managers by investing in the fund the manager oversees.

2. **Ban High Risk Activities and Conflicts of Interest.** Section 13(d)(2) places two fundamental limits on all permitted bank activities: they cannot involve high risk assets or trading strategies and must be free of material conflicts of interest. These limitations on permitted activities needs to be better integrated into the final rule to ensure that banks confine themselves to low-risk, conflict-free transactions. While the Proposed Rule provides strong principles regarding what classifies as a "high risk asset" or a "high risk trading strategy," it does not consistently apply the prohibition on those high risk activities throughout the rule. Worse, the Proposed Rule fails to mention the ban on material conflicts of interest in most of its provisions describing permitted activities. Damaging conflicts of interest pervaded trading activities in the years leading up to the financial crisis, as has been shown by and the Permanent Subcommittee on Investigations[17] as well as a range of investment professionals.[18] They included the failure to disclose material adverse information to unsuspecting investors, abuse of client information obtained through monitoring client trading flows, and structuring products that embedded conflicts of interest between a bank and its customers, or between various bank customers. The final rule should treat the law's ban on high risk activities and conflicts of interest, not as an afterthought, but as a central organizing principle and effective deterrent that needs to be better integrated throughout its provisions.

3. **Provide Clear and Consistent Lines for All Firms.** The Proposed Rule puts forth principles, and then directs banks to figure out for themselves what is, and what is not,

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[16] Report of Exam'r Anton R. Valukas at 59-60, *In re* Lehman Brothers Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. 2010), *available at* http://lehmanreport.jenner.com/.

[17] *See, e.g.*, PSI Report at 719-721.

[18] *See, e.g.*, Philip Augar, THE GREED MERCHANTS: HOW THE INVESTMENT BANKS PLAYED THE FREE MARKET GAME 16-21, 116-22, 216 (Portfolio 2005); 156 CONG. REC. S2691 (daily ed. Apr. 27, 2010) (citing an April 23, 2010 Letter from John Reed, Former Chairman and CEO, Citigroup, to Senators Jeff Merkley and Carl Levin). *See generally* Annette Nazareth, Dir., Sec. and Exch. Comm'n. Div. of Mkt. Reg., Remarks before the SIA Compliance and Legal Division Member Luncheon (Jul. 19, 2005), *available at* http://www.sec.gov/news/speech/spch071905aln.htm; Jeremy Grantham, *Lesson Not Learned: On Redesigning Our Current Financial System*, GMO Q. LETTER SPECIAL TOPIC, 2 (Oct. 2009), *available at* http://www.scribd.com/doc/21682547/Jeremy-Grantham.

proprietary trading. This approach essentially puts the fox in charge of designing the hen house. Instead, the final rule should provide clear guidance through rebuttable presumptions based on asset classes of which activities fall within the scope of a permitted activity and which do not. There are multiple advantages to this approach.

- It would enhance consistency across the banking sector, as banks would all be subject to the same presumptions and interpretations.
- It would enable banks to structure their operations with increased comfort that they are in compliance with the law.
- It would lower the regulatory burden. Compliance requirements for activities covered by the presumptions could be streamlined, while those for activities outside of the presumptions could be more robust. This approach would also dovetail more easily with banks' existing compliance and risk systems.
- It would enhance regulators' ability to identify and focus on risky activities and violations. Much like when a bank examiner reviews loan files or portfolios of financial instruments held for sale or investment, regulators would be able to focus on bank trading activities that are identified as falling outside of the presumptions, as well as testing to ensure that the activities categorized as falling within the presumptions are appropriate. This approach would also aid regulators' ongoing efforts to increase comparative analyses and spot risks across different firms.

4. **Eliminate Unjustified Exclusions and Exemptions.** The Proposed Rule proposes multiple broad exclusions from the "trading account" that have no basis in law, including for repurchase agreements, reverse repurchase agreements, spot commodities, currencies, and general liquidity management. These exclusions should be eliminated, as should several other unnecessary exemptions, such as proposed hedging exemptions related to bank investments in private funds. Rather than creating exclusions or exemptions that place activities entirely outside of the Merkley-Levin restrictions, the final rule should, if the standards for designating a new permitted activity are met under section 13(d)(1)(J), use that mechanism to address the activities at issue.

5. **Utilize capital charges and other restrictions as additional tools.** The Proposed Rule ignores the language of the statute that "permitted activities" are "subject to ... any restrictions or limitations" that your agencies determine. In particular, the final rule should apply capital charges and conduct-based restrictions to ensure that banks engaging in permitted activities are not taking undue risks. These tools could be used, for example, to reduce risk when banks engage in complex securitizations or other novel or complex financial transactions in which regulators have no reliable risk analysis. While capital and liquidity rules alone are not enough to protect against financial vulnerabilities, the final rule should not ignore these tools.[19]

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[19] *See* Simon Johnson, *Where is the Volcker Rule?*, N.Y. TIMES, Dec. 15, 2011, *available at* http://economix.blogs.nytimes.com/2011/12/15/where-is-the-volcker-rule/. A recent study by The ClearingHouse found that some financial firms that met Basel III equity capital requirements of 7 percent still required taxpayer bailouts of up to 30 percent of Tier 1 capital. The ClearingHouse, *"How much capital is enough?" Capital Levels and G-SIB Capital Surcharges*, 3 (Sept. 26, 2011), *available at* http://www.theclearinghouse.org/index.html?f=072896/.

6. **Collect, centralize, and analyze more data.** Many banks and regulators failed to monitor or fully recognize the dangers building up in banks' short-term trading books, off balance sheet transactions, and investments in private funds, due in part to overreliance on inadequate or faulty risk modeling.[20] A simple survey of financial crises throughout history makes clear that firms have, and will again in the future, fail to accurately appreciate the risks associated with some financial products. The Merkley-Levin Provisions give regulators the authority and obligation to gather data to better understand and monitor the risks associated with banks' trading positions. The Proposed Rule's data collection and reporting requirements are a solid step forward. Establishing a centralized data repository or data sharing protocol across regulators is also critical to those efforts.

7. **Enhance Disclosure and Unleash Private Market Enforcement Mechanisms.** The final rule should better align competitive interests with compliance interests. Disclosure, a foundation of efficient markets, should be better used as a tool to prevent evasion of the new restrictions and reward compliance.[21] Recently, industry leaders and academics have recognized the need for better public disclosure of firms' risk modeling and asset portfolio.[22] Investors and customers, including mutual funds, pension funds, and other institutional investors, should be able to see a bank's metrics and evaluate whether the bank they use for various services is actually engaging in high risk activities, trading against them, or accumulating poor quality assets. Trading partners should know the risks their counterparties pose to them, and corporate treasurers should know that their deposits, which in many cases exceed FDIC insurance amounts, will be safe. Disclosure can help make compliance and financial stability a competitive strength, realigning bank management incentives away from dangerous risk-taking and towards client-serving activities.

8. **Hold Boards and CEOs Accountable for Compliance.** The final rule should require the board of directors and chief executive officer of each bank to make an annual assessment and sign a certification of the effectiveness of the bank's internal controls and policies to implement the Volcker Rule. This annual management assessment and certification would facilitate regulatory oversight and encourage effective implementation

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[20] *See* Erik Gerding, *The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis: Code, Crash, and Open Source*, WASH. L. REV., forthcoming, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1273467.

[21] Market discipline based on disclosure, among other tools, is one of the three pillars on which the Basel Agreements is built. *See* Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version* (June 2006), *available at* http://www.bis.org/publ/bcbs128.pdf; Basel Committee on Banking Supervision, *Enhancement to the Basel II Framework* (July 2009), *available at* http://www.bis.org/publ/bcbs157.pdf; Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (Dec. 2010, rev. June 2011), available at http://www.bis.org/publ/bcbs189.pdf. See* also DANIEL TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION 175 (2008) (expressing skepticism regarding the scope of disclosures).

[22] *See* Vikram Pandit, *Apples v apples – a new way to measure risk*, FIN. TIMES, Jan. 10, 2012, *available at* http://www.ft.com/intl/cms/s/0/90bb724a-3afc-11e1-b7ba-00144feabdc0.html#axzz1jT2D5hEK; *see* Gerding, *supra.*

by establishing the "tone at the top," one of the more powerful ways to change the culture of a firm.

With these general comments in mind, we now offer comments on specific elements of the proposal.

II. Definition of Proprietary Trading

1. Scope of Trading Account

The scope of the trading account is one of the most important elements of ensuring a meaningful implementation of the Volcker Rule. Congress mandated that the trading account be interpreted broadly. While certain aspects of the Proposed Rule's approach to the trading account deserve commendation, as currently drafted, the Proposed Rule does not cover enough ground. The definition of the "trading account" put forth by the Proposed Rule is far too narrow to reflect the language or the intent of the Merkley-Levin Provisions.

The Proposed Rule sets out to capture trading positions taken (i) for the purpose of short-term resale; (ii) with the intent of benefitting from actual or expected short-term price movements; (iii) to lock in short-term arbitrage profits; or (iv) to hedge another trading position.[23]

Although the description in the Proposed Rule of the types of arbitrage and other activities that are captured appear to be fairly broad in some respects, the Proposed Rule nevertheless appears to take an overly narrow view of the concept of "short-term," essentially defining it as a period of 60 days or less. Specifying such an overly narrow time period is contrary to the statute, increases the complexity of the rule, and invites gamesmanship. For accounts not covered by the Market Risk Capital Rule or as dealer activities, the final rule should extend coverage to accounts where positions are taken for up to one year.

Nothing in the statutory text or legislative history of the Merkley-Levin Provisions confines the definition of "short-term" to "hours and days, rather than months or years," as stated in the Proposed Rule.[24] Indeed, many proprietary trades occur over months or years. Some swaps nominally extend over a period of years, for example, while requiring changes in the value of the positions held by participants to be reported daily, weekly, monthly or quarterly.[25] The Federal Reserve currently permits financial holding companies to take merchant banking positions for up to 10 years. As recent history has demonstrated, some of the most dangerous proprietary trading positions were held beyond a 60-day window, including positions that led to the collapse of Long-Term Capital Management, the 2006 collapse of a hedge fund known as Amaranth Advisors LLC due to poor commodity trades, the collapses of multiple financial firms during the 2008 financial crisis, and the recent collapse of MF Global due to bad currency bets.[26]

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[23] 76 Fed. Reg. 68846, 68857 (Nov. 7, 2011).

[24] 76 Fed. Reg. at 68859 (Nov. 7, 2011).

[25] Collateralized debt obligations (CDOs) using embedded credit default swaps are one common example. Long-term interest rate swaps and total return swaps are additional examples.

[26] On Long-Term Capital Management, *see* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 102-10 (2001); Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, J. OF ECON. PERSPECTIVES, Spring 1999, at 189-219. On Amaranth, *see* "Excessive

The statutory language directs your agencies to cover "any such other accounts" as your agencies determine. There is no limiting factor in that statutory direction. There is nothing in the text or the legislative history of the Merkley-Levin Provisions that would suggest that Congress intended this direction to have no meaning, or that Congress expected that such discretionary authority would be narrowly used. To the contrary, Chairman Volcker, we, and others have repeatedly expressed the intent for the provisions to cover longer term holdings. Nevertheless, the Proposed Rule ignores the statutory language and legislative history, and instead focuses exclusively on an overly narrow interpretation of "short term" positions.

Broad coverage of the trading account is critical to ensuring that the protections of the Volcker Rule work. Quite simply, the economics matter. If a firm is holding onto a position in a way that it principally profits from price changes in the instrument and it is being held for a period that indicates the holding was not a long-term investment or the extension of credit, then that should be considered prohibited proprietary trading. For example, "merchant banking" investments may be practically indistinguishable from private equity investments, which are restricted by the Proposed Rule. Yet the Proposed Rule does not contemplate addressing merchant banking investments, because it views them as longer-term positions. Merchant banking as well as other investments lasting up to one year should be presumptively covered in the final rule.[27]

Using an overly narrow time period also invites gamesmanship. For example, to circumvent the Merkley-Levin Provisions, banks might begin to specify certain transactions as having a 90-day or year-long duration, even though the participating parties expect to exit the transaction much sooner. Further, banks may take trading positions with no definitive trading horizon at all, and claim they fall outside the scope of the Proposed Rule.[28]

The use of a time period has added significance because, under the Proposed Rule, a transaction that is not within the trading account may be treated as outside of the data collection requirements and regulatory oversight mandated by the Merkley-Levin Provisions.

Speculation in the Natural Gas Market," before the Permanent Subcommittee on Investigations, S. Hrg. 110-235 (Jun. 25 and Jul. 9, 2007), including trades described on pages 268-75, 284-86, and 337-38. On the financial crisis, *see, e.g.*, Report of Exam'r Anton R. Valukas at 59-60, *In re* Lehman Brothers Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. 2010), *available at* http://lehmanreport.jenner.com/; *see also* FIN. CRISIS INQUIRY COMM'N, THE FIN. CRISIS INQUIRY COMM'N REPORT (Jan. 2011), *available at* http://www.fcic.gov/report at 35, 55-56, 177, 196-97, 202-04, 223, 226-28, 256-57, 260-61, 280-81. On MF Global, *see* Christine Harper, Michael J. Moore, and Silla Brush, *MF Global's Collapse Exposes Prop-Trading Risk that Volcker Wants to Curb*, BLOOMBERG, Oct. 31, 2011, *available at* http://www.bloomberg.com/news/2011-10-31/mf-global-exposes-prop-trading-risk-that-volcker-wants-to-curb.html; *see also* John Carney, *The Trade That Killed MF Global*, NETNET, Nov. 2, 2011, *available at* http://www.cnbc.com/id/45132384.

[27] However, we also note that the Proposed Rule correctly covers any position that is captured by the Market Risk Capital Rule or undertaken by a bank in the course of serving as a securities dealer, municipal securities dealer, a government securities dealer, a swap dealer, or a security-based swap dealer. 76 Fed. Reg. at 68859-60.

[28] In the run-up to the financial crisis, many firms accumulated positions during the securitization process because certain portions of those deals could not be readily sold. *See, e.g.*, Merrill Lynch's positions: John Cassidy, *Subprime Suspect: The Rise and Fall of Wall Street's First Black C.E.O.*, New Yorker, Mar. 31, 2008, at 78, 86-88. *See* also PSI Report at 669 (loss of $562 million by Goldman due to its inability to sell all of the Timberwolf securities on its books). The final rule should capture those positions.

Simplifying the rule's coverage will simplify the rule itself and avoid regulatory disputes over what types of accounts and transactions are subject to heightened scrutiny to prevent proprietary trading, high risk, and conflicts of interest. We also note that covering "short-term" positions in this way would not limit the ability of a bank to hold liquidity positions, since those positions could be separately treated as a permitted activity, as discussed further below.

2. Excluded positions

One of the most ill-advised aspects of the Proposed Rule is its creation of a raft of exclusions from the definition of "trading account" for a variety of transactions, including trades in actual commodities or currencies,[29] repurchase agreements and reverse repurchase agreements,[30] and trades conducted pursuant to asset liability management.[31] These exclusions were not contemplated by the statute, create new complexities, undermine the law, and should be stricken.

a. Statutory Structure

The Merkley-Levin Provisions do not provide any statutory authority to create exclusions from the definition of "trading account." To the contrary, it authorizes the regulators only to expand the definition of "trading account" to include "any such other accounts" as they determine. Thus, regulatory discretion is only in one direction.

Positions held outside of the "trading account," as defined by the statute and as should be expanded by the regulators, are not directly covered by the restrictions in the Merkley-Levin Provisions against proprietary trading, much less their protections against high-risk assets, conflicts of interest, and other protections.

The definition of "trading account" was carefully worded in the statute to take into account multiple concerns and deliberately designed to have a broad reach. The statute does not contemplate or provide for exclusions from this definition. If regulators want to allow a new permitted activity, then they must do so pursuant to the authority under Section 13(d)(1)(J), which would ensure that the new activity remained subject to the other limitations in the law applicable to all permitted activities. In short, there is no legal standing for these regulatory-created exclusions from the definition of "trading account," and they should be removed.

b. Spot Commodities and Currencies

The law provides no statutory authority to exclude transactions involving spot commodities or forward contract transactions that are to be physically settled from the Merkley-Levin Provisions, nor should they be excluded. Until relatively recently, banks and their affiliates were not major players in physical commodities. Today, some banks have become major traders of physical commodities, using transactions which can be high risk, give rise to off balance sheet or other hidden liabilities, and involve difficult risk analysis. For example, some banks such as JPMorgan and Morgan Stanley are reportedly trading and storing physical quantities of crude oil

[29] 76 Fed. Reg. at 68850, 68864.
[30] 76 Fed. Reg. at 68850, 68857, and 68862.
[31] 76 Fed. Reg. at 68850, 68857, and 68862-63.

and other physical commodities,[32] and engaging in trading activities and investments that regulators may be hard pressed to analyze for risk or conflicts of interest.

In addition, these transactions invite the very types of conflicts of interest that the Merkley-Levin Provisions are designed to prevent, since those same banks frequently engage in commodity transactions with and on behalf of their clients.[33] Although these types of transactions are not explicitly named in the statute, they are covered under the "any other security or financial instrument" language of Section 13(h)(4). In addition, excluding these types of transactions from the statute would create incentives for banks to circumvent the law by designing transactions utilizing these exclusions. In addition, given the strong relationships between spot commodities and their corresponding futures, excluding spot commodities would create a significant loophole that would undermine the intent of the provisions. Given the risk of evasion, all of these transactions should be subject to the Volcker Rule safeguards.

c. Repurchase and Reverse Repurchase Agreements

Section 13 also provides no statutory authority for the proposed complete exclusion of repurchase and reverse repurchase agreements from the definition of "trading account."

While repurchase agreements and reverse repurchase agreements may, in normal market conditions, specify specific prices, quantities, and times for the trades, they still provide the parties with significant market, liquidity, and counterparty risks. Indeed, they are required to be covered in the trading account for bank accounting purposes and as such are subject to value-at-risk and other indices of market risk.[34]

As was seen during the financial crisis, repurchase agreements can be highly sensitive to fluctuations in market values, liquidity issues, and counterparty risks in ways that are only partially captured by current value-at-risk methodologies and regulatory risk analysis and oversight. They also may raise conflict of interest issues, since many repurchase agreements involve the pledging of client-owned collateral.

A blanket exclusion of these transactions from the reach of the Merkley-Levin Provisions is particularly problematic, since repurchase and reverse repurchase agreements can be structured to effect proprietary trades and engage in material conflicts of interest. The collapse of Lehman Brothers' short-term repurchase agreements offers one of many examples of how financial institutions have used these agreements to engage in a range of complex, high-risk trading

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[32] *See, e.g.*, Ned Molloy, *Energy Risk Oil & Products House of the Year 2011: JP Morgan*, Risk.net, Jun. 9, 2011, *available at* http://www.risk.net/energy-risk/feature/2072271/energy-risk-oil-products-house-2011-jp-morgan; Moming Zhou, *Traders Boost Oil Storage on Offshore Tankers by 75%, Morgan Stanley Says*, BLOOMBERG, Apr. 26, 2010, *available at* http://www.bloomberg.com/news/2010-04-26/traders-boost-oil-storage-on-offshore-tankers-by-75-morgan-stanley-says.html; *Wall Street Banks Quarterly Commodities Trading Risk*, REUTERS, Oct. 18, 2011, *available at* http://www.reuters.com/article/2011/10/18/commodities-banks-risk-idUSN1E79H0M920111018.

[33] *See* Saule Omarova, 63 U. MIAMI L. REV. 1041 (2009).

[34] *See* 12 CFR part 3, Appendix A (OCC); 12 CFR part 208, Appendix A and 12 CFR part 225, Appendix A (Board); and 12 CFR part 325, Appendix A (FDIC).

activities intended to be captured by the Volcker Rule prohibitions.[35] The recent failure of MF Global, which was driven by large proprietary trades on European sovereign debt conducted through repurchase agreements, is another example.[36]

There is simply no statutory or policy justification for excluding repurchase and reverse repurchase agreements from the definition of "trading account" and, in turn, from the Merkley-Levin Provisions. Accordingly, this exclusion should be removed from the final rule.

d. Liquidity Management

The next proposed exclusion from the trading account, for transactions undertaken to manage liquidity needs, is also highly troubling. The proposed exclusion, which also has no statutory basis, is unnecessary and would add enormous complexity to the definition of trading account. It should be eliminated.

In theory, asset liability management seeks to match a bank's exposures on the asset side of its balance sheet with those on its liability side – most commonly, taking into consideration interest rates – in order to ensure appropriate liquidity for the bank. Liquidity management is already the subject of upcoming Basel Committee and Dodd-Frank proposed rules to reduce risk. It also overlaps with permitted "risk-mitigating hedging activities," as well as securitizations, discussed below. Addressing liquidity concerns through those rules is no reason for excluding liquidity management activities from the reach of the Merkley-Levin Provisions. The exclusion instead creates significant confusion. Instead, a better approach would be to coordinate the two sets of rules, so that liquidity management transactions are undertaken in low-risk, conflict-free ways. For example, a well-designed implementing rule could create incentives for banks to use liquidity management transactions that involve the trading of government securities – a low-risk activity already permitted by the Merkley-Levin Provisions.

Excluding asset liability management transactions from the Merkley-Levin Provisions would require banks and regulators to expend resources on identifying which transactions qualify for the exclusion, a complex undertaking that could also generate expensive and time-consuming disagreements. For example, if repurchase agreements were not excluded from the trading account, but asset liquidity management transactions were, considerable effort would be required to distinguish between the two and determine which types of repurchase agreements should be deemed excluded from trading accounts subject to the Volcker Rule. Expending resources on those issues would achieve little in the way of accomplishing the objectives of the Volcker Rule – to prevent proprietary trading and private fund investments by banks (as well as restrict those activities by systemically significant non-bank financial companies).

A better approach would be to drop the proposed exclusion and treat all asset liability management transactions as subject to the Merkley-Levin Provisions. This approach would reduce the rule's complexity and implementation costs, and the covered transactions would be screened to prevent proprietary trading, high risks, and conflicts. In addition, regulators could

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[35] *See, e.g.*, OCCUPY THE SEC, *Volcker Rule, Round One: What's Wrong with the Repo Exclusion?* (Dec. 15, 2011), *available at* http://occupythesec.nycga.net/2011/12/15/volcker-rule-round-one-whats-wrong-with-the-repo-exclusion/.

[36] *See* Harper, *supra*; Carney, *supra*.

designate low-risk versions of those transactions as within designated safe harbors for "permitted activities" under Section 13(d)(1)(J). The five criteria set forth in the Proposed Rule would be a good starting point for describing such a permitted activity, although careful attention should be paid to whether additional rules, for example governing compensation, are needed.

e. Derivatives Clearing Organization and Clearing Agencies

The next proposed exclusion from the definition of trading account involves positions taken in the course of acting as a derivatives clearing organization (DCO). Again, this exclusion has no statutory basis and is troubling. It is unclear why positions taken by a registered DCO in the course of its clearing operations would be less in need of monitoring than other positions undertaken by a bank. While DCOs are subject to special rules related to carrying out their duties, that is no reason to exclude their trading operations from review for proprietary trading, high risk activities, or conflicts. Again, if this activity conforms to the requirements of Section 13(d)(1)(J), then a new permitted activity subject to appropriate metrics and monitoring is the approach authorized by the statute.

f. Questions Regarding Other Exclusions

The Proposed Rule raises questions regarding further expanding the types of transactions to be excluded from the definition of "trading account," including those involving transactions that cannot be hedged in two-way markets (Question 44), those involving illiquid assets (Question 45), and those involving mutual funds and exchange traded products. There is no statutory basis for these suggested exclusions to the trading account definition, and no legislative history to suggest that Congress intended any such exclusions. None of the additional proposed exclusions should be added to the rule.

Both Question 44 and Question 45 appear to refer to illiquid financial instruments, such as customized derivatives, customized asset-backed securities, or over-the-counter derivatives. Creating an exemption for illiquid assets from the trading account has no basis in the law and would dramatically narrow the scope and purpose of the Merkley-Levin Provisions. Illiquid assets can be proprietary in nature, high risk, and involve as many conflicts of interest as liquid assets, so there is no reason to exclude them from the Volcker Rule simply because they are difficult to value or sell. To the contrary, they are precisely some of the assets that the Volcker Rule was most intended to target. During the 2007-2008 financial crisis, for example, banks designed and sold customized mortgage-backed securities; cash, synthetic and hybrid CDOs; credit default swaps; ABX index swaps; and other financial instruments. Many of these products were illiquid and could not be readily or easily hedged in two-way markets. Excluding these types of instruments from the Volcker Rule simply because of their illiquidity is not only contrary to the plain language of the statute, but also the intent of the Volcker Rule.

A separate question is whether the holding of those positions may be appropriate for market-making or other permitted activities. For example, a bank may structure a customized derivative or structured product wherein it assumes a one-sided exposure, and hedge that exposure through ongoing trades.[37] To the extent that the asset can be and is fully and accurately hedged and sold

[37] Nicholas Dunbar, "The Volcker Rule and Financial Innovation" presentation to *Making the Volcker Rule Work*, Americans for Financial Reform conference, Nov. 9, 2011, *available at* http://ourfinancialsecurity.org/blogs/wp-

off within a short period of time, the bank may be providing a client service. However, to the extent that the asset cannot be or is not hedged and sold off, it may be an impermissible proprietary position.

The statute provides a special conformance period for illiquid assets acquired prior to the Dodd-Frank Act's enactment to allow banks that hold interests in private equity funds to avoid disrupting commitments that may spread over a period that would otherwise exceed the ordinary statutory compliance period. We can conceive of no circumstances under which any special carve-out should be extended to other assets based on their liquidity or illiquidity.

The Proposed Rule also raises questions about the appropriateness of excluding from the trading account interests in affiliated registered investment companies, such as mutual funds and exchange-traded products, when sponsored by the bank. Again, there is no statutory basis for excluding these types of financial instruments from the Merkley-Levin Provisions. In addition, mutual funds and exchange-traded products can be designed to achieve proprietary trading objectives.[38] While exchange traded products, such as notes, swaps, and funds, may be designed to provide a client service, they may also function as "captive" proprietary trading counterparties for the sponsoring entity. In those instances, the sponsoring bank may be engaging in pure proprietary trades. Indeed, the recent "rogue trader" scandal involving UBS involved reportedly unauthorized proprietary trading in structured products, including exchange traded funds.[39]

There is no statutory or policy justification for excluding illiquid instruments, instruments that are difficult to hedge, or structured products from the definition of "trading account" and, in turn, from the Merkley-Levin Provisions. These proposed exclusions should be removed from the final rule.

III. Permitted Underwriting, Market-Making Related Activities, and Risk-Mitigating Hedging Activities

Despite the general prohibition on proprietary trading, the Merkley-Levin Provisions expressly permit banks to engage in certain activities to reduce risk or assist clients, so long as those activities are not high risk or suffer from material conflicts of interest. As discussed above, if the Proposed Rule were to expend greater effort delineating the scope of those permitted activities – essentially creating safe harbors – it would strengthen industry compliance with the rule, reduce complexity and regulatory discretion, and simplify and strengthen enforcement efforts. Although a certain degree of discretion is necessary to give supervisors the ability to capture proprietary trading wherever it emerges,[40] the final rule needs to offer greater clarity with respect

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content/ourfinancialsecurity.org/uploads/2011/11/AFR-Volcker-Conference-Nicholas-Dunbar-Presentation-11-9-11.pdf].

[38] Id.

[39] *See* Jesse Eisinger, *In Trading Scandal, A Reason to Enforce the Volcker Rule*, N.Y. TIMES, Sept. 28, 2011, *available at* http://dealbook.nytimes.com/2011/09/28/in-rogue-trading-scandal-a-reason-to-enforce-the-volker-rule/.

[40] For example, some banks' liquidity management and treasury functions were operated as a trading profit center. *See* UBS AG, Shareholder Report on UBS's Write-Downs, (2008) *available at* https://www.static-ubs.com/global/en/about_ubs/investor_relations/share_information/shareholderreport/_jcr_content/par/linklist_0/link_1.1304036023.file/bGluay9wYXRoPS9jb250ZW50L2RhbS91YnMvZ2xvYmFsL2Fib3V0X3Vicy9pbnZlc3RvcI

to permitted activities, starting with underwriting, market-making-related activities, and risk-mitigating hedging activities.

1. Permitted Underwriting Activities (Question 79)

Traditionally, underwriting has been central to the capital raising process that supports the real economy. Underwriters often help design stock or bond offerings, lead preparation of the offering materials, obtain credit ratings for the financial instruments, help make the initial sales of the stocks and bonds, and then help build a secondary market for the stocks and bonds by providing market-making services. In some cases, the underwriter makes a "firm commitment" to sell a certain dollar amount of the stocks and bonds, and is financially liable for that amount. Underwriters also serve a critical investor protection function by providing the first line of defense against securities fraud.

Underwriting was, for many decades, handled by securities firms rather than banks, but in recent years, bank affiliates have become active in the underwriting field. In many cases, underwriting does not require the bank to take on a large amount of risk. The underwriter's liability for the unsold securities or bonds may be limited, and its responsibilities may lie more in providing advice and market-making services than in financing the initial sale of the stocks or bonds.

In some cases, underwriting involves precisely the type of proprietary, high risk, and conflict of interest concerns targeted by the Volcker Rule. Underwriting securitizations and structured products, for example, has in the past required the sponsor to assume large principal positions prior to the underwriting – especially if the sponsor designed the securities or structured products at issue. In addition, securitization tranching means that the underwriter must sell multiple types of securities, which can be difficult and may require the sponsor to retain certain portions of the securities.

In the run up to the 2008 financial crisis, underwriters engaged in multiple high risk securitization underwritings that involved both proprietary trading and conflicts of interest between the sponsor and the clients who bought the resulting securities.[41] For example, the Senate Permanent Subcommittee on Investigations detailed four collateralized debt obligations (CDOs) underwritten by Goldman Sachs.[42] Three of those CDOs, known as Hudson, Anderson, and Timberwolf, involved proprietary trades in which Goldman created and used the CDOs to reduce its liability for poorly-performing mortgage backed securities or mortgage loans. Goldman knew that the CDOs contained poorly performing assets but sold them to its clients anyway. It also bet against each of these CDOs and made money when they lost value at the expense of the clients to whom it had sold the securities. The fourth CDO, known as Abacus, had been requested by and designed to benefit a particular client who shorted the transaction, an

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[41] *See*, generally, NICHOLAS DUNBAR, ALL THE DEVIL'S DERIVATIVES: THE UNTOLD STORY OF THE SLICK TRADERS AND HAPLESS REGULATORS WHO ALMOST BLEW UP WALL STREET AND ARE READY TO DO IT AGAIN (2011); Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 984-91 (2009).

[42] PSI Report at 619-718.

underwriting transaction so full of hidden conflicts of interest that the SEC fined Goldman $550 million for selling the Abacus securities to unsuspecting investors.

Against this backdrop, the Proposed Rule appears to follow Congressional intent to allow banks to engage in basic underwriting that does not involve proprietary trading. However, insufficient effort is deployed to limiting these underwritings to securities that do not involve high risks or conflicts of interest.

Proposed Criteria. The Proposed Rule requires banks wishing to engage in underwriting to meet certain criteria, including that:[43]

- the bank maintain an internal compliance program;
- the covered financial position that is being purchased or sold is a security;
- the transaction is effected solely in connection with a distribution of securities for which the banking entity is acting as an underwriter, as such terms are defined by SEC;
- to the extent registration as a dealer with the appropriate oversight authority is required, that registration is obtained;
- the underwriting be designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties;
- the underwriting activities be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income, and not from appreciation in the value of covered financial positions it holds related to such activities or the hedging of such covered financial position; and
- the compensation arrangements of persons performing underwriting activities at the banking entity must be designed not to encourage proprietary risk-taking.

These criteria provide important safeguards that should be maintained, refined, and strengthened in the final rule.

One criteria, in particular, which requires that underwriting compensation be generated primarily from fees, and not from price appreciation of the underlying securities, is important, but needs further refinement in the context of underwriting securitizations. In the securitization context, fee-based compensation structures did not prevent banks and their affiliates from accumulating large and risky trading positions with significant market risk exposures. Fee-based compensation structures in fact drove increased retention and concentration of risk, effectively resulting in securitization desks putting on proprietary carry trades of high risk assets.[44] An improved approach would be to require the compensation to be linked in part to risk minimization for the securitizer and in part to serving customers. If the securitizer wishes to retain some of the securities or bonds in its longer-term investment book, that decision should be made by a separate officer, subject to different standards and compensation.

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[43] 76 Fed. Reg. at 68866-68869.

[44] *See, e.g.*, FCIC REPORT, *supra*; Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REV. 195, 199-204 (2009); Wilmarth, *supra*, at 1032-34; John Cassidy, *Subprime Suspect: The Rise and Fall of Wall Street's First Black C.E.O.*, NEW YORKER, Mar. 31, 2008, at 78, 86-88; Jake Bernstein & Jesse Eisinger, *Banks' Self-Dealing Super-Charged Financial Crisis*, PROPUBLICA (Aug. 26, 2010), *available at* http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis.

With respect to underwriting related to securitization and structured products, additional guidance may be required to guard against the special risks present in this activity. For the purposes of securitization, an underwriting should likely be seen as the distribution of all (or nearly all) of the securities related to a securitization (excluding that required for credit risk retention purposes) along a time line "designed not to exceed reasonably expected near term demands of clients, customers, or counterparties." The goal would be to minimize the arbitrage and risk concentration possibilities that can arise through the securitization and sale of some tranches with the retention of other tranches.[45]

High Risk and Conflicts of Interest. The statute's "limitations on permitted activities" means that banks cannot underwrite high risk securitizations and structured products, or put their interests in conflict with its clients, customers, or counterparties. The Proposed Rule needs to make this point plainly to prevent the types of high-risk, conflict-ridden transactions that contributed to the 2008 financial crisis and proved highly damaging to U.S. financial stability.

Specifically, significantly enhanced conflicts of interests rules should be set out. We discuss some of these points this below. Among other measures, the final rule should include a cross-reference to Section 621 of the Dodd-Frank Act, which bars conflicts of interests in asset-backed securities and synthetic asset-backed securities.

To facilitate and simplify compliance, the rule could be strengthened by providing a presumption of a safe harbor for underwriting efforts that meet specified low-risk criteria, including that the underwriting be in plain vanilla stock or bond offerings, including commercial paper, for established businesses and governments, and that the distribution be completed within relevant time periods, determined by asset classes (looking to the size of the issuer and the market served), and other indications of ordinary underwriting. Clarifying this type of safe harbor activity would help simplify the rule, promote bank compliance, reduce complexity, encourage low-risk transactions, and streamline regulatory oversight and enforcement.

2. Permitted Market-Making-Related Activities

The Merkley-Levin Provisions also expressly permit banking entities to engage in "market-making-related" activities. Market-making is a customer service provided by financial firms to encourage the secondary trading of stocks, bonds, or other financial products. Market makers promise to stand willing to buy or sell designated financial instruments in order to facilitate client acquisition and disposition of those instruments.[46] Market-making plays an important role in facilitating the smooth functioning of certain capital markets. For example, market-making in U.S. Treasuries plays an important role in the buying and selling of government securities, in the

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[45] This approach does not conflict with the purpose or implementation of risk retention rules found in section 941 of the Dodd-Frank Act. Those rules are designed to ensure that firms are not transferring risks to clients that they would be unwilling to hold themselves. They are generally designed to ensure that securitizers hold slices of risk that are representative of and sensitive to the risks being sold. *See* letter from Jeff Merkley, U.S. Senator, and Carl Levin, U.S. Senator, to Elizabeth M. Murphy, Sec. and Exch. Comm'n (Jan. 12, 2012), *available at* http://www.sec.gov/comments/s7-38-11/s73811-15.pdf.

[46] *See e.g.*, 15 U.S.C. 78c(a)(38). *See also,* 73 Fed. Reg. 61690, 61698-99 (Oct. 17, 2008) and Letter from Ams. for Fin. Reform, to the Fin. Stability Oversight Council (Nov. 3, 2010), *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-1328.1.

conduct of U.S. monetary policy, and in the healthy plumbing of the financial system.[47] Similarly, market-making helps ensure reasonable levels of liquidity in sovereign, municipal, and corporate bond markets and in U.S. equity markets.[48] In exchange for receiving certain benefits in the marketplace because of their positions, market makers are also required to meet certain obligations, such as being willing to provide a two-sided market in all market conditions.

Market-making generally contemplates holding a limited inventory of the financial instruments being traded for a limited period of time to ensure a well-functioning secondary market. Specialists on the New York Stock Exchange floor, the stereotypical market-makers, famously try to be "flat" by the end of the day, if not within minutes of each trade. Their objective is not to make money by holding onto inventory that appreciates in value, but rather on the spread that represents the financial intermediation service being provided to clients.

The challenge in Volcker Rule implementation is distinguishing inventories compiled for legitimate market-making activities from inventories compiled for impermissible proprietary trading. In this respect the Proposed Rule should be enhanced, including by: (1) developing presumptions of safe harbors based on asset classes for low-risk market-making-related activities; (2) distinguishing between market-making-related activities to facilitate client trades of pre-existing financial instruments versus to facilitate bank sales of custom-made or novel products originated by or for the bank; (3) strengthening provisions to prevent conflicts of interest; and (4) strengthening provisions to prevent high risk assets and high risk trading strategies, as well as discouraging market-making related activities involving illiquid assets, as further explained below.

Proposed Criteria. The Proposed Rule requires a banking entity seeking to engage in market-making-related activities to meet a number of documented criteria, including that the banking entity :

- maintain an internal compliance program;
- provide a regular and continuous two-sided market, consistent with established rules on market-making;[49]
- ensure its activities are designed not to exceed reasonably-expected near term demands of clients, customers and counterparties;
- be a registered dealer in securities, futures, or swaps, domestically or internationally, as appropriate;
- earn most of its revenues from fees and commissions, including the bid-ask spread, and not from the price appreciation or arbitrage of price changes in the assets; and
- compensate its traders based on customer service and not to reward gains from price appreciation or arbitrage of price changes in the assets.

These criteria are easy to understand, relevant, and faithful to the law.

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[47] Perry Mehrling, NEW LOMBARD STREET: HOW THE FED BECAME THE DEALER OF LAST RESORT 92-139 (2011).
[48] Lawrence Summers and Victoria Summers, *When Financial Markets Work Too Well: A Cautious Case For a Securities Transaction Tax*, 3 JOURNAL OF FINANCIAL SERVICES RESEARCH 261-286 (1989); Philippon, *supra*.
[49] *See, e.g.*, 73 Fed. Reg. 61690, 61698-99 (Oct. 17, 2008).

One of the most important criteria is the proposed restriction on trader compensation. Many commentators have noted that compensation is likely to be one of the best ways to ensure compliance with the Volcker Rule's restraints. Thus, regulators should demand, and in some cases clearly specify how, banks align the incentives of their traders in favor of compliance with the Merkley-Levin Provisions. Compensation arrangements should counter the tendency among traders to engage in riskier trading in search of higher personal rewards. Two promising ideas are to pay traders only after a given position is exited, and to adjust any compensation for volatility and other risk factors. In some cases, banks may want to make a trader's compensation inversely correlated to specified risk factors, such as the maintenance of positions that are not tightly hedged or are kept too long.

The requirement that banks may carry only inventories that are designed to meet reasonably expected, near-term customer demand is also key to distinguishing between client-oriented and proprietary market-making-related activities. Determining whether a market-maker's inventory is reasonably proportional to customer demand can be fairly easily measured. Stock and bond inventories can be expected to vary with the specifics of the particular market, the size of the customer base being served, and expected customer demand; banks should be required to demonstrate how their inventory practices, policies, and actual inventories are responsive to those factors.

Also deserving of support is the proposed criteria that the bank provide a regular and continuous two-sided market for the financial instruments in its inventory, consistent with rules established by the relevant market regulators. Put another way, to qualify as a permitted "market-making-related" position, a bank must have or reasonably expect at least two customers, one for each side of the trade. And it must have a reasonable expectation of the second customer coming and taking the position (or risk) off its books in the "near term." The existence of a two-sided market is particularly relevant in less frequently traded instruments. For example, if a bank obtains a position in response to engaging in a trade with one customer, that bank may take that position only to the extent that it has a reasonable expectation that another customer will come by in the "near term" to buy it. If a trader "reasonably expects" that a trade will compel the bank to hold onto a position for a longer period of time (but not for a sufficient period of time to qualify as an investment book position), that trade – even though it was initially taken in response to a customer request – is still a proprietary trade, because it is inventory that exceeds the "reasonably expected near term demands of clients, customers, or counterparties."[50]

The key to effective implementation of this criterion is not to focus on a trader's belief or intent, but on objective measures regarding the rate of turnover of assets in the inventory held by the bank. Banks should collect this inventory data, evaluate it, develop policies on how to handle particular positions, and make regular adjustments to ensure a turnover of assets commensurate with client near-term demand. Again, the data should be collected and analyzed by asset class to take into account variances in how different types of financial instruments are traded, for example, how the stocks and bonds of smaller companies trade as compared to those of larger companies. The Proposed Rule would be strengthened if it specified the types of inventory metrics that should be collected.

[50] Section 13(d)(1)(B) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*).

Underwriting versus Market-Making. One of the weaknesses of the Proposed Rule is its failure to address the issue of underwriting versus market-making-related activities. The financial crisis is replete with examples of financial firms that originated, underwrote, and sold poorly performing financial instruments to clients. As mentioned earlier, the Permanent Subcommittee on Investigations described four different CDOs that Goldman Sachs designed, underwrote, and marketed to clients.[51] In all four cases, Goldman marketed CDO securities that it had designed and expected to perform poorly. In three of the cases, Goldman shorted some or all of the CDO assets, without disclosing its viewpoint or actions to the clients to whom it was recommending and marketing the CDO securities. In the fourth, Goldman recommended the securities to clients without disclosing that the assets had been selected to lose value and so generate a profit for the client who held the short side of the transaction.

When asked about its activities, Goldman claimed to have acted as a "market maker" rather than an underwriter in selling the CDO securities.[52] Goldman also claimed that its inventory of unsold CDO securities should be viewed as integral to its market-making efforts, instead of evidence of an effort to rid its books of the poorly-performing CDO securities it had originated.[53] Such assertions defy the common understanding of the term, market-making.[54] Goldman, pursuing its own self-interest, created new financial products so that it could obtain the exposure it wanted and then sold the opposite exposure to clients. That effort is proprietary trading at its most conflicted. It is not, nor could it or should it be, considered market-making.

The final rule should make it clear that, where a bank is attempting to sell to clients financial instruments that it originated, rather than facilitating a secondary market for client trades in previously existing financial products (such as third-party stocks), its activities ought to be analyzed in the context of permitted underwriting activities rather than permitted market-making-related activities. The final rule should also make it clear that inventories of financial instruments that a bank has originated will be viewed as an inventory compiled for proprietary trading purposes that may also give rise to conflict of interest concerns, in contrast to an inventory of previously existing instruments compiled for purposes of assisting client trades. Drawing bright lines between these two types of inventories is critical to effective implementation of the Merkley-Levin Provisions.

Conflicts of Interest. Another weakness in this part of the Proposed Rule is its failure to address with sufficient particularity how conflicts of interest are to be eliminated in the context of market-making-related activities. The Permanent Subcommittee on Investigations has detailed how, during the run up to the financial crisis, Goldman traded mortgage related products – which it characterized as market-making activities – that created conflicts of interest between Goldman and its clients.

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[51] PSI Report at 619-718.

[52] *See, e.g.*, PSI Report at 728-32; "Wall Street and the Financial Crisis: The Role of Investment Banks," before the U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 111-674, Volume 4, (April 27, 2010), at 134 (statement of Lloyd Blankfein, CEO and Chairman, Goldman Sachs Group, Inc.).

[53] *See* PSI Report at 728-32. Goldman may have been making this claim in part to escape the higher duties under the federal securities laws assigned to underwriters versus market-makers. *See* PSI Report at 722.

[54] *See* 73 Fed. Reg. 61690 (Oct. 14, 2008); FIN. STABILITY OVERSIGHT COUNCIL, STUDY AND RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 18-19, 28-29 (2011).

In 2007, for example, Goldman twice built and profited from trading activities which resulted in large short positions in mortgage related securities, generating record profits for the Goldman Mortgage Department at a time when most other financial institutions were experiencing losses. Goldman's first net short peaked at about $10 billion in February 2007, and the Mortgage Department as a whole generated first quarter revenues of about $368 million, after deducting losses and write-downs on subprime loan and warehouse inventory.[55] The second net short, referred to by Goldman Chief Financial Officer David Viniar as "the big short," peaked in June at $13.9 billion. As a result of this net short, one Goldman trading desk generated third quarter revenues of about $2.8 billion, which were offset by losses on other mortgage desks, but still left the Mortgage Department with more than $741 million in profits.[56] Altogether in 2007, Goldman's net short positions from buying and selling mortgage related products generated net revenues of $3.7 billion.[57] These positions were so large that the Mortgage Department repeatedly breached its risk limits, and Goldman's senior management responded by repeatedly giving the Mortgage Department new and higher temporary risk limits to accommodate its trading. At one point in 2007, Goldman's Value-at-Risk measure indicated that the Mortgage Department was contributing 54 percent of the firm's total market risk, even though it ordinarily contributed only about 2 percent of its total net revenues.[58]

To build its net short positions, Goldman's Mortgage Department used a variety of trading strategies, some of which lasted minutes, others of which lasted months. They included selling its long mortgage-related assets; shorting RMBS securities, CDOs, and the ABX index; and taking the short side of synthetic CDOs.[59] Senior Goldman executives directed and monitored these activities. As Goldman CEO Lloyd Blankfein explained in an internal email to his colleagues in November 2007: "Of course we didn't dodge the mortgage mess. We lost money, then made more than we lost because of shorts."[60]

While Goldman has often characterized its trading as market-making-related activities undertaken on behalf of clients, the evidence indicated many were actually undertaken to advance Goldman's proprietary financial interests.[61] The Levin-Coburn report stated:

> "Several factors suggest that transactions undertaken to build and profit from Goldman's two large net short positions in 2007 were completed for Goldman's own benefit, rather than on behalf of its clients. First, the two net short positions – totaling $10 billion in February and $13.9 billion in June 2007 – were far larger than a financial institution

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[55] PSI Report at 481-618.
[56] PSI Report at 560-66.
[57] PSI Report at 566-67.
[58] PSI Report at 550-59. "Value-at-Risk" or VAR is a key risk measurement system used by Goldman. At a 95% confidence level, VAR represents the dollar amount a business unit could expect to lose once every 20 trading days or about once per month. Subcommittee interview of Craig Broderick (4/9/2010). *See* also Philippe Jorion, "Value at Risk: The New Benchmark for Managing Financial Risk," at 20 (3d ed. 2007).
[59] PSI Report at 492-510, 534.
[60] PSI Report at 463.
[61] *See, e.g.*, PSI Report at 752 ("[M]any of the transactions undertaken by the [Goldman] Mortgage Department from late 2006 to late 2007 appear to have been undertaken to advance the financial interests of the firm, rather than primarily to make markets for clients."); and at 732-34 ("Goldman's internal documents, emails, and interviews indicate that, from late 2006 through 2007, Goldman was not always responding to client demand, but was also aggressively soliciting customers in an attempt to sell its CDO and RMBS products.").

would establish simply to meet anticipated client demand. Second, the magnitude of the risk attached to those short positions was also outsized ... incur[ring] up to 54% of firm wide risk. The Subcommittee uncovered no evidence to suggest that Goldman incurred and sustained that disproportionately high level of risk to accommodate client demands or to hedge positions taken on to accommodate clients. A third factor ... was how long Goldman held onto them. For example, the Mortgage Department maintained a $9 billion ABX AAA short for six to nine months in 2007. ... The Subcommittee found no evidence indicating that the $9 billion short was maintained over such a long period of time to accommodate client demand."[62]

Whether the transactions were the result of proprietary trading or market-making-related activities, it is clear that Goldman profited from them at the expense of the clients with whom it traded in 2007.[63]

As currently drafted, the section of the Proposed Rule on market-making-related activities does not mention the statutory prohibition on activities that "would involve or result in a material conflict of interest ... between the banking entity and its clients, customers, or counterparties." Nor does it provide examples of or warn against particular conflicts, such as recommending that clients buy poorly performing assets in order to remove them from the bank's books or attempting to move market prices in favor of trading positions a bank has built up in order to make a profit. The final rule should directly address these conflict of interest issues when discussing market-making-related activities. Providing specific examples and direction will also facilitate industry compliance.

Revenue Issues. As former FDIC Chairman Sheila Bair has noted, the requirement that revenues from market-making fees exceed revenue from price appreciation or arbitrage is an important factor to prevent market-making activities from being used as a cover for proprietary trading.[64] The final rule should make it clear that banks seeking to rely on the market-making-related permitted activities provision may not generally seek to profit from the price movements of the inventories themselves. At the same time, banks' market-making-related activities may give rise to modest and relatively stable profits arising from their limited inventory.[65] A well-structured trading operation should be able to obtain relatively high ratios of revenue-to-risk (as measured by various metrics), low volatility, and relatively high turnover. Failure to do so, and reliance on significant market risk or arbitrage exposures for profits, should raise red flags.

Additional red flags should go up when revenues from price appreciation become significant with respect to the value of the securities being transacted, become volatile, or grow out of proportion to the risk undertaken with the security. In such cases, regulators should treat that revenue as evidence of proprietary trading rather than market-making-related activities. The

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[62] PSI Report at 752-53.

[63] *See, e.g.*, PSI Report at 463-64, 499-503.

[64] Sheila Bair, *We Need a New Volcker Rule for Banks*, FORTUNE (Dec. 9, 2011), *available at* http://finance.fortune.cnn.com/2011/12/09/volcker-rule-sheila-bair/; *A New Regime for Regulating Large, Complex Financial Institutions: Hearing Before the Subcomm. On Financial Institutions and Consumer Protection of the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 13 (2011) (statement of Sheila Bair, Senior Advisor, Pew Charitable Trusts).

[65] William L. Silber, *On the Nature of Trading; Do Speculators Leave Footprints?*, J. PORTFOLIO MGMT., Summer 2003, at 64, 64-70.

final rule would be improved if these types of red flags and the underlying metrics needed to spot them were identified for both banks and regulators.

Some mutual funds, institutional investors, and hedge funds (so-called "buy side" firms) have expressed concern, that this criterion could increase their trading costs or reduce their liquidity. No convincing, independent evidence yet exists, however, indicating those problems will occur to any appreciable extent. Indeed, the best evidence available suggests that the buy side firms would greatly benefit from the competitive pressures that transparency can bring, as opposed to the opaque costs embedded in the current system.

In addition, if banks are prohibited by the Merkley-Levin Provisions – as intended – from absorbing large or illiquid positions because they may not be able to readily unload the positions or the risk, other non-banks are expected to step into the marketplace to act as ready counterparties. The fear that our marketplaces cannot function unless banks bear huge risks from holding illiquid or large asset inventories is flatly contradicted by the flourishing market activity that took place while the Glass-Steagall Act was in place and prohibited securities trading by U.S. banks.

Trading Volume. Some critics of the Volcker Rule warn that if banks are not permitted to engage in unlimited trading of particular assets, such as sovereign bonds, or build inventories of large or illiquid positions, trading volumes will collapse, financial markets will suffer, and investors and financial systems will be damaged. Again, the history of trading under the Glass-Steagall Act contradicts those predictions. If a bank takes on a trading position involving high risk, illiquid assets, or simply a large volume of assets, the attendant risk is also borne in part by the bank's depositors and U.S. taxpayers. Minimizing that risk is a key objective of the Merkley-Levin Provisions. Thus, the final rule should make clear that, if a bank can demonstrate a track record or reasonable expectation that it can unload a trading position in the near term, and the trading position does not entail high risks or conflicts of interest, then it may assume that trading position in reliance on the permitted activity for "market-making-related" activities. On the other hand, if a bank does not reasonably foresee being able to unload that position in the near term, and does not seek to hold it as a long term asset (such as in its investment book), then taking on that trading position would violate the Volcker Rule.

If banks are less able to take those risks on, then the efficiency of the capital markets would pull other would-be counterparties into the markets to replace the banks. Further, it should be noted that because this ability to unload market risk on banks today may arguably lower explicit trading costs, that does not mean that it may lower overall trading costs. To the contrary, a bank (with its taxpayer backing), may actually absorb the risk and profit at the expense of the buy side counterparty.

Illiquid Assets. One provision in the Proposed Rule which raises significant concerns and should be eliminated would allow banking entities to engage in market-making-related activities involving "illiquid instruments, in particular, instruments that 'trade by appointment.'"[66] This concept is new in the securities laws, as regulators' previous guidance addressed market making in the context of liquid markets, such as by a designated market maker on the New York Stock

[66] 76 Fed. Reg. at 68871-74.

Exchange. Generally, to engage in market-making, markets must be at least modestly liquid, so that market-makers can execute trades on both sides of the transaction at issue. Notably, even the Proposed Rule distinguishes between the longstanding regulatory guidance regarding market-making in liquid instruments, and this new regulatory concept of market-making in illiquid instruments.[67]

The provision to allow market-making related activities for illiquid financial instruments would significantly undermine the objectives of the Volcker Rule. Because there is no effective "market," engaging in these transactions cannot be "market-making-related." Compiling an inventory of them would not be to facilitate further client trades but to either take a prohibited proprietary trading position or attempt to create a market where little or none exists. Illiquid financial instruments, in particular complex or customized products, are also difficult to value, and reliance on internal risk modeling undermines the reliability of bank capital as a buffer against loss. Illiquid assets that cannot be reliably valued are precisely the type of high-risk asset that is inappropriate for bank market-making. It should be noted that this is not a prohibition on the existence of the asset, but a recognition that the Volcker Rule makes trading the asset inappropriate for banks in connection with their market-making-related activities.

Again drawing on the body of evidence compiled by the Permanent Subcommittee on Investigations, during the financial crisis, Goldman experienced great difficulties in trying to sell illiquid CDO securities that it had designed and underwritten. In the case of the Timberwolf CDO, Goldman used a host of hard sell tactics to convince clients to buy the securities.[68] When it was unable to sell all of the Timberwolf securities on its books, Goldman suffered a loss.[69] In its efforts to avoid that loss, Goldman recommended the Timberwolf securities to its clients without disclosing Goldman's negative view of the securities or the fact that it held a significant portion of the short side of the CDO, raising the very conflicts of interest the Volcker Rule is intended to prevent.[70]

Market-making activities involving illiquid instruments are simply not the type of plain vanilla, low-risk capital activities that the Volcker Rule intends to permit for banks.

There is no statutory text or legislative history that supports the creation of the proposed novel regulatory concept of "market making" in "illiquid" instruments or "trade by appointment" assets. The statute deliberately used the term "market-making-related" so as to plug into existing regulatory interpretations.[71] For those reasons, the provisions in the Proposed Rule that would allow banks to engage in market-making related activities involving "illiquid" assets or instruments that "trade by appointment" should be stricken.

Data Collection. The Proposed Rule makes great strides in outlining necessary data for collection and analysis by banks and their regulators to implement the Volcker Rule. Comprehensive data collection is central to ensuring that market-making-related activities are client-oriented, rather than disguised proprietary trading in circumvention of the Volcker Rule's

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[67] 76 Fed. Reg. at 68870-74.
[68] PSI Report at 657-64.
[69] PSI Report at 669.
[70] PSI Report at 719-64. *See* also PSI Report at 732-34.
[71] *See, e.g.*, 73 Fed. Reg. 61690 (Oct. 14, 2008).

restrictions. The proposed rule outlines approximately 20 metrics that could be used to distinguish the permitted activities from proprietary trading.

The proposed metrics can be grouped into five broad categories:

- Risk-management measurements – VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits;

- Source-of-revenue measurements – Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution;

- Revenues-relative-to-risk measurements – Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio, Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss, Unprofitable Trading Days based on Portfolio Profit and Loss, Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss;

- Customer-facing activity measurements – Inventory Turnover, Inventory Aging, and Customer-Facing Trade Ratio; and

- Payment of fees, commissions, and spreads measurements – Pay-to-Receive Spread Ratio.[72]

If collected at the trading desk level and at appropriate levels above, the metrics outlined by the Proposed Rule would provide useful data on a bank's trading patterns and risk profile. The identification of those metrics is one of the strengths of the Proposed Rule and offers great promise for successful implementation of the Volcker Rule. Since many of the metrics provide information critical to understanding a bank's trading operations and risks, a good number of them are already prepared and analyzed in some form today. By expanding, standardizing, and deepening this data collection and reporting, the Volcker Rule offers regulators the opportunity to collect and analyze key data that would advance a range of regulatory objectives, beyond implementing the Volcker Rule.[73] Obtaining a better understanding of trading activities would, for example, strengthen risk analysis, lead to more informed supervision of banks individually, and support sharper macro-prudential analysis across the financial system.[74] In addition to the agencies participating in the Proposed Rule, the Office of Financial Research (OFR) should be given access to this data so that it can provide centralized analysis and monitoring to identify any trends giving rise to systemic risk.

Presumptions. As the Proposed Rule observes, the proposed data collection is useful in supervising compliance with the proposed criteria for market-making related activities (as well

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[72] 76 Fed. Reg. at 68884.

[73] Briefing by Mark E. Van Der Weide, Senior Associate Director, Division on Banking Supervision and Regulation, to Congressional staff (Oct. 19, 2011).

[74] *See* Hon. Daniel Tarullo, Governor of the Fed. Res. Board of Governors, *Regulating Systemically Important Financial Firms*, Speech before the Peter G. Peterson Institute for International Economics (June 3, 2011), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm.

as underwriting, risk-mitigating hedging, and other permitted activities) only if the rule also explains how the data should be interpreted and applied. The Proposed Rule attempts to provide that guidance for market-making-related activities in Appendix B. Although Appendix B contains useful provisions, it needs to be supplemented with clear presumptions to aid traders, risk managers, and regulators. These presumptions should be designed to identify not only prohibited conduct, but also the scope of permitted activities.

Appendix B identifies several factors whose presence would lead to a presumption by a regulator that a specified activity involves proprietary trading as opposed to market-making-related activities. Although the presumption can be rebutted with "explanatory facts and circumstances," the factors that give rise to a presumption of proprietary trading are when:

- Retained risk exceeds that necessary to provide intermediation services to customers;
- Revenues from price movements in assets exceeds revenues from fees for services;
- Revenue to risk ratios are exceedingly unbalanced or show high volatility;
- Non-customer trading activities exceed customer activities;
- Fees are paid *by* the firm; and
- Compensation incentives to employees reward proprietary risk taking.

Each of these factors provides evidence of possible proprietary trading. The presence of one or more of these factors should, because of the presumption, essentially shift the burden of proof with respect to the activity in question. In other words, if one or more of the factors raises a red flag, it should no longer be the obligation of the regulator to prove that proprietary trading is taking place; it should be the obligation of the bank to establish that it is not.

While each of the selected factors provides evidence of "proprietary trading," warrants regulatory attention, and justifies a shift in the burden of proof, some require subjective judgments, are subject to gaming or data manipulation, and invite excessive reliance on circumstantial evidence and lawyers' opinions. Even worse, each bank is charged with identifying what these factors mean and how they should be evaluated.

To address these problems, in addition to the broad factors outlined in the Proposed Rule, specific presumptions should be added to provide bright-line guideposts indicating when particular activities should be treated as presumptively within the scope of a "market-making-related activity." This approach, which could apply across the banking sector, would create presumptions of safe harbors for activities that comply with the Volcker Rule.[75]

For example, Appendix B could deem market-making-related activities involving widely traded stocks and bonds issued by well-established corporations, government securities, or highly liquid asset-backed securities as the type of plain vanilla, low-risk capital activities that are presumptively permitted under the Volcker Rule. Such a presumption would need to specify that inventories of the particular assets being traded, when kept within certain parameters (including in relation to capital and turnover), would be presumptively deemed as client-oriented inventories. Such a presumption must also include bright lines for revenue-to-risk metrics,

[75] If one of the presumptions of compliance also results in a red flag under a presumption of violation, regulators will have to examine the books and use their judgment. As patterns emerge, regulators will be able to refine their approach and will become more adept at identifying significant violations.

volatility, and hedging. This approach would, in essence, help establish specified safe harbors in the area of market-making related activities, rather than concentrate solely on identifying prohibited activities.

To be useful, presumptions would need to be developed for each relevant asset class, such as stocks and bonds (varying by type of issuer and depth of the market), asset-backed securities, commodity futures, options, and specific kinds of swaps. This approach would be similar to the Basel capital regime, and could be based on objective, easy-to-understand metrics that measure risk and client-oriented transactions.

The purpose of this approach would be to facilitate compliance by bank management and enforcement by supervisors. Trading desk managers would be able to give clear directions to traders, and supervisors would have real numbers against which to measure compliance. Activities within this compliance regime may trigger additional review, which would require supervisory discretion for example, based on volatility or unusual revenue patterns, but the starting point would be a clearly delineated, and well-understood, set of market-making-related activities that *can* be conducted and are presumptively within the range of permitted activities under the Volcker Rule. Such an approach could reduce the likelihood of gaming.[76]

At the same time, banks would not be prohibited from venturing outside of the designated safe harbors, but should expect and encounter greater regulatory scrutiny for such activities, including a much higher risk of running afoul of the general presumptions on impermissible proprietary trading. Market-making-related activities outside of the specified safe harbors should also require additional capital charges and limits on margin trading to prevent high risk.[77] This approach would help align the Volcker Rule implementation framework with the evolving framework for monitoring the trading book currently underway at the Basel Committee. Indeed, achieving this alignment is one of the key reasons why the statute provides regulators with authority to set capital charges in Section 13(d)(3). Of course, the limitations on conflicts of interest and high-risk assets and trading strategies still apply.

The use of metrics and presumptions as described here are not intended to and cannot replace regulatory review of the actual specific trading positions held by banks. Direct monitoring of positions has been part of the Federal Reserve's written bank supervision policies for many years.[78] Regulators have indicated, however, that they look to those manuals as mere guidance, and the more predominant practice of recent years has been to focus simply on monitoring risk management systems. The financial crisis taught that regulators cannot avoid the hard work of

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[76] On gaming risks, *see* Malcolm Salter, *Lawful but Corrupt: Gaming and the Problem of Institutional Corruption in the Private Sector*, Harvard Business School Working Paper 11-060 (2010), *available at* http://www.hbs.edu/research/pdf/11-060.pdf; *see* also Gerding, *supra*.

[77] William R. Hambrecht, *Making the Volcker Rule Work for America: A Pragmatic Alternative to Exemptions* (Nov. 9, 2011), *available at* http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2011/11/Bill-Hambrecht-Volcker-Rule-Paper-11-9-11.pdf.

[78] *See, e.g.*, Commercial Bank Supervision Manual, Federal Reserve System, Sec. 2030.3 #9, *available at* http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf; Bank Holding Company Supervision Manual, Federal Reserve System, Sec. 2125.0, *available at* http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc.pdf; Trading and Capital Markets Activities Manual, Federal Reserve System, Sec. 2050.1, *available at* http://www.federalreserve.gov/boarddocs/supmanual/trading/200901/0901trading.pdf.

scrutinizing actual trading positions and questioning them – much the way community bank examiners review banks' books and question actual loans. It is the positions that can and do lose money, not risk management systems. For example, in today's environment, regulators and internal bank supervisors should examine all holdings in European sovereign debt, regardless of whether any risk or other metrics are triggered.

Increased Disclosure. Finally, regulatory review of market-making-related activities should be supplemented by rules requiring banks to disclose their trading positions and Volcker Rule metrics to market participants on a delayed, but periodic basis. Customers of a bank, including buy-side investors like mutual funds, pension funds, insurance companies, and hedge funds, are intended to benefit from the Volcker Rule in knowing that the banks they use for trading services are not engaged in proprietary trading to their disadvantage. In addition, investors in banks, especially senior bondholders and unsecured creditors (such as large corporate depositors), should know the extent to which a firm is in compliance with the Volcker Rule because such information bears directly on the safety of their money. Such information will also be helpful to the bank's competitive position, both domestically and internationally, a point emphasized in the proposal put forward by Citigroup CEO Vikram Pandit to provide for risk disclosure of firms' trading positions.[79]

3. Permitted Risk-Mitigating Hedging Activities

A third activity that is expressly permitted in the Merkley-Levin Provisions is "risk-mitigating hedging activities." These hedging activities are permitted, because they reduce risk at banks, one of the primary objectives of the Volcker Rule. In order to qualify as "risk-mitigating hedging," the Proposed Rule:

- requires a hedge be "reasonably correlated" with the underlying asset;[80]
- requires the hedge be related to "specific risks";[81]
- permits hedges on "individual or aggregated positions," including through hedges on a "portfolio basis,"[82] and
- requires that compensation arrangements for hedges not reward proprietary trading.

In general, these criteria carry out the intent of the Merkley-Levin provisions, in particular the requirements that hedges reduce specific risks and not add any new levels of risk. Also important is the requirement that compensation arrangements not reward proprietary trading in hedging activities. At the same time, as many have noted, hedging is one of the more challenging areas to regulate, and the Proposed Rule needs to be refined, both to guard against abuse and to facilitate compliance.

Specifically, the Proposed Rule should: (1) strengthen the hedging standards; (2) remove the provision allowing hedging on a portfolio basis; (3) close a compensation loophole involving private fund managers; (4) strengthen provisions enabling regulators to monitor a bank's hedging activities; (5) strengthen prohibitions on conflicts of interest; and (6) provide additional detail

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[79] *See* Pandit, *supra*.
[80] 76 Fed. Reg. at 68875.
[81] 76 Fed. Reg. at 68875.
[82] 76 Fed. Reg. at 68875-78.

with regard to compensation practices that align the interests of traders with Volcker Rule compliance.

Hedging Standards. Under the statute, hedging must be risk-mitigating, which the Proposed Rule correctly notes. But the Proposed Rule also undermines that statutory mandate by allowing hedges that have only a "reasonable correlation" with the asset being hedged. That weak standard is insufficient to ensure that hedges are being used to lower risks rather than make covert proprietary trades. The final rule should require hedges to have a high correlation with both the underlying asset and the specific risk that is being mitigated in *both* calm and stressed markets.

Moreover, the final rule should guard against abuse. Long-Term Capital Management engaged in highly advanced statistical models regarding their hedging strategies, yet suffered massive losses when the stressed markets behaved contrary to their models.[83] When banks use complex hedging techniques or otherwise engage in trading that is suggestive of arbitrage, regulators should require them to provide evidence and analysis demonstrating what risk is being reduced. Asset classes that are particularly hard to hedge, such as options, should be given special attention. Proper hedges should significantly reduce the risk volatility on the relevant trading desk as compared to the market for the asset being traded. A demonstrated reduction in risk volatility and magnitude should be key indicators of whether hedges are, in fact, mitigating risk.

Attention should also be particularly dedicated towards preventing reliance on hedges using assets where counterparty credit exposures magnify risks, especially during a system-wide stressed event. Such "hedges" may not actually reduce risk, but in fact aggravate it during a crisis by transmitting failures across the system. In addition, regulators may want to consider as impermissible hedges that use financial products that are neither exchange traded nor cleared.

Portfolio Hedging. One major weakness in this part of the Proposed Rule is allowing hedging on a portfolio basis. Hedging on a portfolio basis essentially allows banks to view an investment portfolio as a whole and take actions to offset a particular type of risk that appears in the portfolio. This contrasts sharply to professional traders who have told us that hedges are, by far, most effectively utilized as actual hedges when matched on a position by position basis, and not on a portfolio basis.

As many have noted, banks could easily use portfolio-based hedging to mask proprietary trading.[84] In addition, it opens the door to evasion of the requirements that hedges be carefully tied to specific risks, and actually reduce those risks. For example, it allows a firm to engage in so-called hedging transactions at a high level that are not meaningfully tied to the firm's underlying positions. A portfolio-wide hedging strategy could arguably enable two trading desks that are covertly involved in proprietary trades to "hedge" one another—somewhat like saying

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[83] *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2001).

[84] Scott Patterson and Victoria McGrane, *Taking a Bite Out of 'Volcker': Draft Proposal of Namesake Rule Would Allow Banks to Make Bets Using Their Own Capital*, WALL ST. J., Sept. 22, 2011 (quoting Robert Litan, "If you can do portfolio hedging, that gives you a license to do pretty much anything.").

that a proprietary bet on oil would be offset by a proprietary bet on mortgages.[85] The risk of this so-called "portfolio hedging" effectively sanctioning what is really proprietary trading is exacerbated by the relatively loose standard that a hedge need be only "reasonably correlated" to the underlying asset. Moreover, even reasonably correlated hedging could result in proprietary trading, along the lines of relative value arbitrage.

There is no statutory basis to support the proposed portfolio hedging language, nor is there anything in the legislative history to suggest that it should be allowed. To the contrary, the legislative history of this provision clearly rebuts any assertion that such a broad allowance should be made. We introduced the first draft of what later became the Merkley-Levin Provisions as S.3098 on March 10, 2010. In that legislation, the permitted activity was worded only as "risk-mitigating hedging activities."[86] During the legislative process, this language was significantly revised to remove the possibility for portfolio hedging. The final language of the statute permits:

> Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts or other holdings.[87]

The concept of portfolio hedging is antithetical to this statutory requirement that each hedge be "in connection with and related to individual or aggregated positions, contracts, or other holdings." The reason why forty-two words were added between our first bill's introduction and the final language used in the statute was to make sure that every single position taken as a hedge would be tied to a "specific risk" arising from another "specific" position, whether that position is an individual holding a certain asset or an aggregation of the positions of that particular asset. The use of the term "aggregate" positions is to give comfort that firms do not have to hedge on a trade-by-trade basis, but only on a position-by-position basis.

In fact, when a bank takes a position that it categorizes as permitted "risk-mitigating hedging," it should be able to point to the exact position(s) that it is seeking to hedge, and it must be able to show how its "risk-mitigating hedge" varies with changes to the risk of the position(s) it is seeking to hedge.

As it is unsupported by the statute, the legislative history, and meaningful implementation of the Merkley-Levin Provisions, the proposed allowance for "hedging on a portfolio basis" should be removed.

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[85] So-called "portfolio hedging" could allow different parts of a bank to proprietary trade in ways that the bank could say are "hedges" for one another, since the risks might somewhat offset. For example, the mortgage department might short mortgages as a proprietary bet while the corporate debt department might go long as another proprietary bet. On a "portfolio level", banking regulators might conclude that those positions hedge each other out.

[86] *See* Protect Our Recovery Through Oversight of Proprietary Trading Act of 2010 (PROP Trading Act), S. 3098, 111th Cong. (2010).

[87] Section 13(d)(1)(C) of the Bank Holding Company Act of 1956.

Compensation Loophole. A second problem with the Proposed Rule's "risk-mitigating hedging" language is that it creates an indefensible loophole to the proposed restriction on compensation arrangements for hedges. While it is difficult to understand, the Proposed Rule appears to suggest that a bank could "hedge" a contractual promise to compensate a manager of a private fund. Presumably because this promise creates liability for the bank, the Proposed Rule would permit the bank to take an equity position in the private fund beyond the 3%-3% limit in the law, and use any profits from this additional equity position to repay the fund manager.

As an initial matter, this regulator-created loophole has no basis in the statute, and is contrary to the plain meaning of the restrictions outlined in the Merkley-Levin Provisions. Further, it seems to authorize the worst possible kind of proprietary trade. If the fund performs well, then the proceeds of the investment would presumably, if it is an accurate hedge, accrue entirely to the portfolio manager. If the fund performs poorly, then the shareholders of the bank suffer the losses, not the portfolio manager. This peculiar so-called "hedge" could lead to further evasion of the fund investment restrictions, as firms could readily exceed their 3%-3% statutory limits, provided that they have corresponding compensation relationships with their fund managers. Rather than allowing a "risk-mitigating hedge" to offset the risks created by such a contractual promise, the better approach would be to ban the contractual promise in the first place or at least make it clear that such a hedge is unacceptable. The proposed provision should be stricken from the rule.

Monitoring Hedging Activities. Because all hedges contain some residual amount of risk, which can appear in unusual circumstances and result in large losses, the Proposed Rule should also be strengthened by establishing minimum requirements allowing regulators to monitor banks' hedging activities. For example, the rule should provide minimum standards for an internal system that will enable regulators to identify, track, and evaluate hedging activity, including by requiring banks to label all hedges at their inception, and provide information on the specific risk being offset, the expected duration of the hedge, how it will be monitored, and how it will be wound down. The names of the trader, manager, and supervisor approving the hedge should also be collected. Well-managed banks collect and use much of this data already, but the information should be included in the data collection metrics identified earlier to ensure risks are being reduced rather than increased by specific hedges, and to evaluate any costs or revenues being produced.

These systems should enable regulators to monitor hedging activities related to not just a bank's short-term trading account, but also its longer-term investment book. Academic research suggests that banks currently engage in little hedging related to their long-term investment book, except interest rate hedging as a form of asset-liability management.[88] Any significant increase in the amount of hedging related to the long-term investment book may be evidence of evasion of the Volcker Rule's prohibitions on proprietary trading. As noted above, former FDIC Chairman Sheila Bair expressed this concern in testimony to the Senate Banking Committee, arguing that banks may attempt to shift their proprietary activities from the trading book to the

[88] *See, e.g.*, Bernadette Minton, Rene M. Stulz, and Rohan Williamson, *How Much do Banks Use Credit Derivatives to Hedge Loans?*, Fischer College of Business Working Paper Series, Jan. 2008, *available at* http://www.ssrn.com/abstract=1084058.

investment book.[89] As Chairman Bair emphasized, the goal should be a "simple rule based on the underlying economics of the transaction, not on its label or accounting treatment."[90]

Prohibiting Conflicts of Interest. Finally, this portion of the Proposed Rule should be strengthened by addressing the issue of conflicts of interest and strengthening provisions to ensure risk-mitigating hedges are not used in ways that give rise to such conflicts. The 2008 financial crisis has already demonstrated how financial institutions use "hedging" techniques in ways that may create conflicts of interest with their clients. For example, the Permanent Subcommittee on Investigations has detailed how Goldman Sachs originated synthetic CDOs with poorly performing referenced assets, kept the CDO securities on its books while it attempted to sell them to clients, and entered into credit default swaps to reduce or eliminate its financial risk.[91] The Proposed Rule should, at the least, state explicitly that banks may not enter into risk-mitigating hedges that would involve or result in a material conflict of interest between the bank and its clients, customers, or counterparties. It should also include a cross reference to prohibitions outlined in Section 621 of the Dodd-Frank Act.

True risk-mitigating hedging activities are allowed by the Merkley-Levin Provisions for one reason – to reduce risks. These activities are not meant to serve as masks for proprietary trading or justify conflicts of interest.

IV. Other Permitted Trading Activities

In addition to expressly permitting banks to engage in underwriting, market-making-related activities, and risk-mitigating hedging activities, the Merkley-Levin Provisions also permit trading in government securities, trading by regulated insurance companies, and proprietary trading by truly foreign banks. The Proposed Rule does a good job addressing these permitted activities, although it could be further enhanced as indicated below.

1. Permitted Trading in Government Obligations

Section 13(d)(1)(A) of the Bank Holding Company Act deems trading in U.S. government obligations, including U.S. federal, state, and municipal debt of all varieties, to be a "permitted activity" by all banks for two reasons. First, U.S. federal, state, and local government obligations, including that of agencies and other public authorities, are generally low risk. The U.S. government has placed its full faith and credit behind Treasury notes which have served as among the strongest and lowest risk investments in the world for many years, and U.S. states, localities, and their agencies have a long history showing they are similarly strong borrowers. These assets are, thus, less subject to credit and liquidity events. Second, U.S.-based institutions trading U.S. federal, state, and local government securities do not face any foreign exchange risk. This combination means they are significantly less prone to the kinds of disruptive events that

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[89] *A New Regime for Regulating Large, Complex Financial Institutions: Hearing Before the Subcomm. On Financial Institutions and Consumer Protection of the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 13 (2011) (statement of Sheila Bair, Senior Advisor, Pew Charitable Trusts).

[90] *A New Regime for Regulating Large, Complex Financial Institutions: Hearing Before the Subcomm. On Financial Institutions and Consumer Protection of the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 13 (2011) (statement of Sheila Bair, Senior Advisor, Pew Charitable Trusts).

[91] PSI Report at 619-36.

have led to past financial crises.[92] These factors make U.S.-based government securities precisely the type of low-risk activity favored by the Volcker Rule for depository banks. Of course, firms can still lose money from interest rate and other market movements, which is why they are still subject to the limitations on permitted activities, the most relevant being the prohibitions on conflicts of interest and high-risk trading strategies.

In addition, U.S.-based government securities have for many years been used by banks for liquidity management, and as collateral in transactions, including repurchase agreements.[93]

As discussed earlier, the Proposed Rule contemplates excluding liquidity management, repurchase agreements, and derivatives clearing organizations from the definition of trading account in an apparent effort to allow banks to engage in such activities. Such exclusions have no basis in the law, and are neither allowed nor well-advised, since these functions are in large part already taken care of through the statute's permitted trading in government securities, including U.S. Treasuries. The permitted activity of trading in U.S.-based government obligations is the best way to ensure these activities are conducted safely. Indeed, should the final rule provide other means for handling these activities, there would not a policy-based justification for providing a separate permitted activity of trading in government obligations.

Some critics of the Volcker Rule have urged regulators to expand this part of the Proposed Rule to include trading in the securities of foreign governments. Should regulators want to take that action, they must use their authority to create a new permitted activity under Section 13(d)(1)(J), which requires such activities to "promote and protect the safety and soundness of the banking entity and the financial stability of the United States." Permitted activities are also subject to the statutory ban on high risk assets. The Merkley-Levin Provisions do not currently treat proprietary trades in foreign government securities as a permitted activity because in the early half of 2010, when the law was being developed, it was already clear, as it is now, that foreign sovereign debt instruments can be risky instruments. In the aftermath of the collapse of MF Global,[94] which was reportedly the result of failed proprietary trades on foreign sovereign debt, and only 15 years after LTCM's collapse on derivative bets on foreign sovereign debt, it is troubling that some would contend that our financial regulators cannot set limits around such trading by our domestic banks.

At the same time, the Merkley-Levin Provisions do not preclude a bank from holding foreign sovereign debt in its longer-term investment book, or from acting as a market-maker or underwriter in foreign sovereign debt. Because these activities are clearly permitted, they contradict the arguments that the Merkley-Levin Provisions will prevent foreign governments

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[92] Long-Term Capital Management's failure was brought on by the credit and foreign exchange crises brought on following Russia's default on its sovereign bonds. *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2001); Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, J. of Econ. Perspectives, Spring 1999, at 189, 189-219.

[93] Failure to use good collateral, such as U.S. Treasuries, in repurchase agreements was major problem during the financial crisis that was also directly related to trading activities. *See* Gary Gorton, *The Panic of 2007*, in MAINTAINING STABILITY IN A CHANGING FINANCIAL SYSTEM 131, 131-36 (Fed. Reserve Bank of Kan. City ed., 2009), *available at* http://www.kc.frb.org/publicat/sympos/2008/Gorton.03.12.09.pdf; Jane D'Arista, POLITICAL ECON. RESEARCH INST., LEVERAGE, PROPRIETARY TRADING AND FUNDING ACTIVITIES 1 (2009), *available at* http://www.peri.umass.edu/fileadmin/pdf/other_publication_types/SAFERbriefs/SAFER_issue_brief1.pdf.

[94] *See* Harper, *supra*; Carney, *supra*.

from trading their bonds. Foreign governments should also consider the fact that, in recent years, given the current state of financial turmoil abroad, U.S. banks may be shorting rather than selling sovereign bonds. Proprietary trading is not the extension of credit. If a bank wants to buy and hold foreign sovereign debt, then it retains the ability to do so.

Other critics of the Volcker Rule have recently argued that trade obligations such as the North American Free Trade Agreement and the various agreements of the World Trade Organization of which the United States is a signatory do not permit the United States to adopt regulations that distinguish between how U.S. banks treat U.S.-based government obligations compared to foreign-based obligations. Given the risks associated with foreign exchange, however, these interpretations are plainly incorrect. It would be unimaginable – and indeed, contrary to the multinational Basel Agreements on capital – if the prudential exemption to the anti-discrimination mandates of financial services trade agreements did not allow banking regulators' to account for foreign exchange risk. Section 13 does not discriminate in any way against foreign banks' abilities to compete with U.S. banks within U.S. territories. As such, it cannot be argued to be a violation of any trade agreements.

2. Permitted Activities for Regulated Insurance Companies

With respect to insurance companies, Section 13(d)(1)(F) of the Bank Holding Company Act expressly deems the purchase and sale of stocks, bonds, and other assets in the "general account" of a "regulated insurance company," to be a permitted activity. The Proposed Rule faithfully carries out the law by authorizing regulated insurance companies to continue to operate under conservative state insurance rules.[95] It was the existence of these longstanding state insurance law restrictions that led to the Merkley-Levin Provisions deeming these insurance-specific activities at regulated insurance companies to be permitted activities.

In addition, as the Proposed Rule appropriately recognizes, just because a bank has a regulated insurance company, that does not mean that the bank can use its insurance subsidiary to engage in prohibited proprietary trading or impermissible sponsorship of or investment in private funds. To the contrary, the permitted activity is limited to the provision of insurance.

General account investments of a regulated insurance company that are subject to the "insurance company laws, regulations, and written guidance" of the state in which it is domiciled are not intended to be otherwise restricted, unless the regulators determine that the relevant state's insurance rules are inadequate. This provision is intended to generally permit regulated insurance companies to continue to make investments, including as passive investors in third-party hedge and private equity funds,[96] as would otherwise be provided for under state insurance company law, provided that such law does not become a tool of evasion. That said, all such investments, as with any other permitted activities, are subject to the statutory prohibitions against high risk assets, high risk trading strategies, and conflicts of interest.

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[95] *See, e.g.*, 76 Fed. Reg. at 68879.

[96] The statutory text is designed to ensure that the Volcker Rule's prohibition on the sponsorship of a hedge fund and private equity fund not be evaded through ownership of an insurance company. It is not intended to limit insurance companies' abilities to make investment in unaffiliated entities that would otherwise be permitted under state insurance law.

Because insurance affiliates are allowed under state laws to invest a small portion of their investment portfolios in high risk activities, it is conceivable that banks could try to use their insurance affiliates to circumvent the Volcker Rule prohibitions on proprietary trading and conflicts of interest. The Proposed Rule should warn against this misuse of bank insurance affiliates. In addition, to prevent any such evasion and to guard against systemic risk, insurance affiliates of banks should be made subject to data collection and reporting under the Proposed Rule.[97]

3. Permitted Activities for Truly Foreign Banks

Section 13(d)(1)(H) of the Bank Holding Company Act also deems as a permitted activity, proprietary trading by foreign entities in foreign markets with foreign counterparties. The Proposed Rule appears to faithfully and effectively implement this provision of the statute.

The Proposed Rule also poses a question, however, about whether it should exempt foreign affiliates of U.S.-based banks from the Volcker Rule restrictions when they engage in trades with foreign counterparties abroad.[98] Granting this exemption would create a huge loophole in the safeguards created by the Volcker Rule, since U.S.-based parent banks would be placed at risk by the trading of their foreign affiliates, in much the same way that AIG was put at risk by the trading positions of its London-based business unit.[99] The law was carefully drafted to guard against this risk. This proposed loophole has no basis in the statute or legislative history of the Merkley-Levin Provisions and should be rejected.

The purpose of this permitted activity was to recognize principles of international comity and, absent extraordinary circumstances, to permit foreign banks, at the foreign parent level, to engage in activities outside of the United States with other foreign entities that they would otherwise be permitted to undertake under the laws of foreign jurisdictions. It should be so interpreted. The provision was drafted so that proprietary trading conducted outside of the United States by foreign entities could not directly impact the financial condition of a U.S. bank. This bright line would be abrogated if the permitted activity were extended to foreign affiliates of U.S. banks, since their activities would directly impact a U.S. financial institution.

Put simply, allowing foreign affiliates of U.S. banks to engage in proprietary and high risk trades with foreign parties would enable U.S. banks to easily circumvent the Volcker Rule. In some cases, U.S. banks might seek to use offshore shell affiliates, with no physical presence, no employees, and no separate business operations. In another scenario, U.S. banks might move their U.S. trading operations to foreign affiliates, thus costing U.S. jobs, but still leaving the U.S. bank unprotected by the safeguards of the Volcker Rule.

Moreover, the limitations on permitted activities should also be construed for foreign entities relying on this permitted activity with a view towards international regulatory comity. This likely means taking an approach to the high-risk assets and high-risk trading strategies and

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[97] *See, e.g.*, 76 Fed. Reg. 68880 (Question 134).

[98] 76 Fed. Reg. 68882 (Question 141).

[99] *See, e.g., American International Group's Impact on the Global Economy; Before, During, and After Federal Intervention*: Hrg. Before the House Comm. on Fin. Services, 111th Cong. (2009)(statement of Edward M. Liddy, Chairman and Chief Executive Officer, American International Group).

material conflicts of interest limitations on the permitted activity which is different from that which applies to U.S. entities. Such a limitation on permitted activities should be specially constructed to recognize international comity and support global financial stability, for example, by making it contingent upon full compliance with the minimum global standards set by the Financial Stability Board.[100]

V. Reporting and Recordkeeping Requirements Applicable to Trading Activities

1. General Approach to Reporting and Recordkeeping Requirements

Data collection is a key element of the Volcker Rule's ability to contribute to the safety and soundness of the bank and the financial stability of the United States. The Proposed Rule would fill a significant and troubling data gap that has impeded regulators' ability to monitor our nation's largest financial institutions. Indeed, when the Government Accountability Office was tasked with studying proprietary trading, it found that it could not readily perform any thorough analysis in large part because the banks themselves – and their regulators – lacked the relevant records.[101]

We support the Proposed Rule's approach to collecting data at "the multiple layers of a banking entity's organization structure," starting at the lowest level of trading activity – the trading desk.[102] The final rule should make it clear that data collecting responsibilities may even be extended to an individual trader.

Recordkeeping and compliance are critical corollaries to data collection and provide the potential for consistent enforcement across financial firms. Given the speed and volatility of financial transactions, market trends, and crises today, the Proposed Rule is correct to require daily data calculations. Large financial institutions typically already have systems in place that track their investments and risk exposures on a daily basis. Standardizing the types of data produced by those systems may incur some upfront costs, but would produce significant long-term benefits to the banks and to U.S. financial stability. In particular, it will enable federal regulators to compare data across financial institutions and sectors to track trends and spot problems. This is precisely the type of macro-prudential supervisory approach recognized as critical by our leading regulators.[103]

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[100] Such an approach would provide additional teeth in support of consistent implementation of Basel III standards, a major concern of U.S. financial regulators and banks alike. *See* Hon. Daniel Tarullo, *The International Agenda for Financial Regulation*, Speech to American Bar Association Banking Law Committee Fall Meeting (Nov. 4, 2011), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20111104a.htm; Michael Watt, *Fears over consistency of Basel III implementation*, RISK MAGAZINE (Feb. 3, 2011), *available at* http://www.risk.net/risk-magazine/feature/1939764/fears-consistency-basel-iii-implementation.

[101] U.S. GOV'T ACCOUNTABILITY OFFICE, PROPRIETARY TRADING: REGULATORS WILL NEED MORE COMPREHENSIVE INFORMATION TO FULLY MONITOR COMPLIANCE WITH NEW RESTRICTIONS WHEN IMPLEMENTED, GAO-11-529, Jul. 2011, at 2 ("After determining that obtaining data on all potential proprietary trading was not feasible because the firms do not maintain separate records on these activities") and at 13 ("we determined that collecting information on other proprietary trading [beyond merely stand-alone proprietary trading desks] was not feasible because the firms did not separately maintain records on such activities.").

[102] 76 Fed. Reg. at 68885.

[103] *See* Tarullo, *supra*.

One concern is that the Proposed Rule provides for a 30-day delay in financial institutions reporting their daily data to regulators. That lengthy delay may limit the data's utility, especially in stressed markets. In recent years, we have seen very large financial firms collapse very quickly, sometimes over the course of only a couple weeks. While on-site regulators will likely be able to access data at a particular institution on an as-collected basis, the final rule should require systems to be put in place to permit as close to real-time reporting and monitoring as reasonably possible, when necessary.

In addition, the Proposed Rule should be strengthened by providing for a centralized data repository or data sharing protocol to enable a coordinated, consistent oversight and enforcement approach across financial regulators, industry sectors, and even affiliates belonging to the same bank holding company. This data would not only improve regulators' ability to oversee the component parts of what have become enormous, global, financial conglomerates, but also would enable regulators to better meet their new responsibilities under the Dodd-Frank Act to identify, reduce, and prevent systemic risks. The best candidate to take on the responsibility for building and operating this type of centralized database would be the Office of Financial Research (OFR), which has jurisdiction to examine all types of financial activity and whose mission is to collect and analyze financial data. OFR could then share its data compilations and analyses with individual regulators as well as with the Financial Stability Oversight Council.

2. Treatment of Smaller Banks

In general, the activities targeted by the Volcker Rule are conducted at only a handful of the nation's largest financial firms. Given the tremendous damage that their activities caused in the recent past, the ongoing risk posed by them, and the substantial revenues generated by those activities, it is reasonable to require the large financial institutions engaged in those activities to bear the cost of the data collection, recordkeeping, and other compliance requirements of the Proposed Rule. In contrast, smaller banks, such as community banks, that do not regularly engage in proprietary trading, should be spared the necessity of creating a compliance and oversight regime that is not relevant to the activities they engage in. The Proposed Rule's scaled approach takes into account the stark differences in activities among U.S. financial institutions, and is constructed to target the largest financial firms without creating unnecessary compliance requirements for banks that do not generally engage in the types of trading activities that the Volcker Rule is intended to address. The Proposed Rule demonstrates that regulators can and intend to focus their Volcker Rule oversight and enforcement efforts where they are most needed.

Should banks request it, regulators may also wish to prepare easy-to-use guidance, tailored to smaller institutions, regarding the steps they can take to ensure they do not become inadvertently engaged in trading activities that trigger the Volcker Rule. The guidance could address, for example, traditional liquidity management, underwriting of local bond offerings, and risk-reducing hedging techniques that can be used by smaller banks without triggering the reporting requirements relevant to a full-service trading operation. Compliance should be simple and easy, and not interfere with traditional banking activities conducted by these smaller banks. In general, these smaller banks should be given the benefit of the doubt with regards to compliance.

VI. Subpart C – Covered Fund Activities and Investments

Over the last decade, a number of U.S. banks have developed close associations with private hedge funds and private equity funds. Among other actions, the banks have established, purchased, or sponsored those types of funds, provided them with seed capital, advised them on investments, steered investors and business to them, or allocated substantial proprietary funds to their endeavors. It has also not been uncommon for senior personnel at a U.S. bank to leave, start their own hedge fund, and then conduct extensive business with their former employer.[104]

Examples of close relationships between banks and private funds include Deutsche Bank's association with Winchester Capital, a hedge fund based in London; JPMorgan Chase's association with Highbridge Capital Management, which manages multiple hedge funds; and Morgan Stanley's association with FrontPoint Partners, a hedge fund it purchased in 2006 for $400 million.[105] Other banks have established special purpose vehicles (SPVs), which are essentially shell corporations, to serve as off-balance sheet investment funds, including Citigroup and State Street Bank.[106] Those banks typically steered client funds, as well as their own funds, to the investment vehicles they sponsored.

If the Volcker Rule were to fail to address those types of investments and risks, it would fail in its overall objectives.

The Volcker Rule is designed to limit trading activities by banks, whether that trading is recorded on a bank's balance sheet in its trading accounts or through off-balance sheet transactions using private funds or special purpose vehicles. The financial crisis demonstrated how banks that sponsored private funds or SPVs sometimes experienced significant losses, either because their proprietary investments performed poorly or client losses led the bank to bail out the fund. Those bailouts were undertaken, in part, to avoid the reputational harm caused by the client losses and, in part, to prevent the fund's failure from negatively affecting the rest of the financial system.[107] At times, the firms that bailed out their funds had then to be bailed out by U.S. taxpayers.[108] Accordingly, the Volcker Rule sought to limit the exposure of banks to private funds and SPVs, by restricting their ability to sponsor, take ownership positions in, and bail out those funds. Each of these restrictions is important to ensuring that the Volcker Rule's safeguards have their intended effect.

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[104] *See, e.g.*, GSC Partners, a hedge fund that was founded by a former Goldman partner, employed multiple former Goldman bankers, and had a longstanding business relationship with Goldman. PSI Report at 637.

[105] PSI Report at 413 (citing a Mar. 2, 2011 letter from Deutsche Bank legal counsel); Press Release, JP Morgan, Purchase of Highbridge Capital Management (Jun. 11, 2009) *available at* http://www.jpmorgan.com/news/jpmorgan/am/us/press_office/purchase-of-highbridge-capital; Press Release, Morgan Stanley, Morgan Stanley to Acquire FrontPoint Partners (Oct. 31, 2006) *available at* http://www.morganstanley.com/about/press/articles/3820.html.

[106] *See* Raj Date, *Test Case on the Charles*, CAMBRIDGE WINTER CTR. FOR FIN. INSTS. POLICY (June 12, 2010), *available at* http://www.cambridgewinter.org/Cambridge_Winter/Archives/Entries/2010/6/12_TEST_CASE_ON_THE_CHARLES_files/state%20street%20volcker%20061210.pdf.

[107] *See* William D. Cohan, *Inside the Bear Stearns Boiler Room*, FORTUNE, Mar. 4, 2009, http://money.cnn.com/2009/03/02/magazines/fortune/cohan_houseofcards_full.fortune; *See* also FCIC REPORT, at 238-41, 256-57, 260-61, 280-81.

[108] *See*, Date, *supra*; FCIC REPORT 286, *supra* (detailing how the collapses of certain Bear Stearns' funds led to the government-backed bailout of the firm itself).

However, as with the approach throughout the Volcker Rule, the legislation recognizes that the broad prohibition needs to be complemented with certain permitted activities to enable banks to serve clients. The combination of the broad prohibition with certain permitted activities is intended to function as guardrails around the basic services that can be provided within the permitted activities, and thereby facilitate sound risk management practices and reliable oversight by financial regulators.

The Proposed Rule appropriately implements most of the statutory restrictions on bank relationships with private funds and SPVs, but needs to be further enhanced by: (1) placing duration and dollar limits on the amount of seed funds that banks may provide to a fund they are organizing and offering to clients; (2) adding a provision to enforce the statutory restriction that funds sponsored by a bank may be offered to only its existing customers; and (3) striking the proposed so-called "hedging" exemptions.

1. Prohibition on Acquisition or Retention of Ownership Interests in, and Certain Relationships with, a Covered Fund

The Proposed Rule appears to track the statute by prohibiting bank sponsorship of or investment in any fund that relies on an exemption from registration with the SEC as an "investment company." This approach covers a wide variety of funds including vehicles that, based on their trading strategy or organization, are commonly known as hedge funds, private equity funds, or SPVs, but also include joint ventures, corporate structuring vehicles, and other types of funds. The broad scope of this definition was intentional to prevent circumvention of the statute by using complex funds or structuring to avoid coverage.

We also support the decision made in the Proposed Rule to include commodity pools as covered funds, under the statutory authority to cover "similar funds." Commodity pools, like hedge funds and private equity funds, are vehicles that could easily be used by banks to engage in propriety trading. We encourage regulators to carefully monitor any other funds used by banks to ensure they are not circumventing the Volcker Rule.

2. Permitted Organization and Offering of a Covered Fund

Early versions of the Merkley-Levin Provisions would have prohibited banks from organizing or offering any private investment funds under any circumstances.[109] In response to claims that banks could properly use these funds to provide low-risk, plain vanilla asset management services for customers, this absolute prohibition was loosened somewhat. The Merkley-Levin Provisions permit a bank to organize and offer private investment funds, provided that the bank:

- offers the fund as part of fiduciary services to customers of the bank,
- does not guarantee the fund or bail out the fund,
- does not let the fund use the bank's name,
- does not invest more than 3 percent of the equity of any fund or in the aggregate hold more than 3 percent of Tier 1 capital in all such funds, and

[109] *See* Protect Our Recovery Through Oversight of Proprietary Trading Act of 2010 (PROP Trading Act), S. 3098, 111th Cong. (2010).

- reserves at least one dollar of Tier 1 capital for each dollar placed into these funds, which increase as the leverage of the fund increases.

The Proposed Rule implements these statutory mandates by tracking the statutory provisions. At the same time, it weakens the law by failing to address issues related to seed funds, ignoring a statutory requirement that bank-sponsored funds be marketed to only the bank's existing asset management customers, and creating unjustifiable hedging exemptions that have no basis in law.

Seed Funds. First, the Proposed Rule fails to address the issue of "seed funds," despite clear statements of Congressional intent that it do so.[110] The law and the Proposed Rule both state that a bank's investment cannot comprise more than three percent of a fund. But the rule is then silent on how to implement that limit during the initial establishment of a new fund. When a firm creates a new fund, it typically provides the fund's initial capital, often referred to as "seed funds." That amount is likely to exceed the three percent limit due to the lack of other investors. The Proposed Rule needs to make it clear that either the bank must locate other investors from the fund's inception so that it stays within the three percent limit, or provide additional limits on the initial capital investment to carry out the intent of the law.

For example, the final rule should establish a clear limit on the amount of seed funds that a bank may provide to a new fund. We understand that a maximum dollar amount such as $10 million would be sufficient for a fund to build a track record to attract other investors.[111] In addition, the final rule should prohibit any investment that would exceed the statutory three percent limit one year after a new fund is established. Further, the final rule should make it plain that no exemption is available to the statutory mandate that the capital charge for any such investments be made on a dollar for dollar basis. The statutory provisions related to timing and investment were heavily negotiated, and any exemption or extension would be contrary to the plain language of the statute.

Customer Limitation. Second, the language of the statute mandates that funds sponsored by a bank may be offered only to "persons that are customers of such services" of the bank.[112] This statutory language was chosen because banks claimed that they needed to be able to offer new investment funds as a service to their existing asset management customers. The statutory language draws a clear distinction between offering such bank-sponsored funds to the bank's "customers of such services" (under 13(d)(1)(G)(ii)) versus "actual or potential investors in the fund" (under 13(d)(1)(G)(viii)). These two different phrases, within the same sub-paragraph, were clearly intended to have different meanings. The Proposed Rule currently fails, however, to implement this statutory mandate. It should be revised by adding a provision stating that a bank may market a bank-sponsored fund only to the bank's actual, existing customers and may not solicit investors outside of its existing customer base for asset management services.[113]

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[110] 156 Cong. Rec. S5894, 5897 (daily ed. July 15, 2010) (statement of Senator Merkley) ("As a general rule, firms taking advantage of this provision should maintain only small seed funds...").

[111] 156 CONG. REC. S5901 (daily ed. July 15, 2010) (statement of Sens. Merkley, Levin, and Dodd)

[112] Section 13(d)(1)(G) of the Bank Holding Company Act.

[113] 76 Fed. Reg. at 68901-68903 (including Questions 249 and 250).

While this restriction, we recognize that this may put banks offering such investment advisory services at a competitive disadvantage to other non-bank investment advisors, but that is merely a reflection of the strong protections needed – and intentionally put into the law – to guard against the risks such funds pose to banks.

Hedging Exemptions. The Proposed Rule contains several surprising and unwise exemptions to the three percent statutory cap for "hedging" activities to be carried out through bank-sponsored funds, none of which has any basis in the law. For instance, the Proposed Rule would appear to allow banks to engage in investments in their sponsored funds when those investments are designed to hedge other activities of the bank. The Proposed Rule also indicates that those investments may exceed the three percent ownership cap established in the law. The statue and the Proposed Rule already permit banks to engage in "risk-mitigating hedging activities" directly. There is no statutory basis for creating an alternative category of indirect hedging activities through a bank-sponsored fund. This proposal is particularly egregious because it fails to restrict those additional hedging activities to ones that are "risk mitigating." Allowing a breach of the three percent cap, for undefined hedging activities that may be off-balance sheet, would open the door to covert proprietary and high risk investments that the Volcker Rule is intended to prevent. This proposed provision has no statutory basis and should be stricken.

In a second instance, the Proposed Rule would appear to allow a bank to "hedge" by taking an ownership interest in a fund beyond the three percent cap, when it is acting on behalf of a customer to facilitate that client's exposure to the fund. This provision is facially inconsistent with the statute and the legislative history and should be removed from the rule. As an initial matter, the Proposed Rule fails to explain why a bank, acting on behalf of a client, would incur any risk that requires any type of hedge. If the Proposed Rule is instead contemplating allowing complex financial structures in which a bank uses a swap or structured note to give a customer exposure to a fund without the client's investing directly in that fund the rule should explain why such an arrangement fits within the low-risk, plain vanilla investment services that such funds are supposed to provide; explain further why such an arrangement would justify allowing the bank to exceed the three percent statutory cap on its investment in the fund; and set forth the statutory basis for such an exemption. Further, the rule should outline how such a process could work without creating a loophole that undermines the intent and application of the Merkley-Levin Provisions. As it currently stands, the proposed exemption appears to have little justification on the merits as well as being contrary to the three percent limit imposed by law.

Perhaps most startlingly, the Proposed Rule would appear to allow a bank to "hedge" its compensation for fund managers by taking an ownership interest in the fund beyond the 3 percent statutory limit.[114] This provision is egregious as it appears to permit the fund manager to obtain all the upside to his or her "skin in the game" while leaving the bank with all of the downside. Like the other proposed hedging exemptions, this proposal has no statutory basis and should be removed.

All three of the proposed hedging exemptions to the three percent limit would create potentially large and dangerous loopholes and should be stricken from the rule.

[114] 76 Fed. Reg. at 68909-910.

3. Other Permitted Covered Fund Activities and Investments

a. Permitted Investments in Small Business Investment Companies (SBICs) and Related Funds

A Small Business Investment Company (SBIC) is a regulated form of venture capital fund dedicated to investing in small growth companies. SBICs are regulated by and receive loans from the Small Business Administration (SBA). These small business funds have been offered by bank holding companies for many years. The Proposed Rule faithfully implements the statute in continuing to permit banks to sponsor SBICs.

The Proposed Rule poses several questions about whether the permitted activity of sponsoring SBIC funds should be expanded to include all venture capital funds or loan funds.[115] It should not. The statute does not provide for these additional permitted activities. Recent studies have suggested that bank capital makes up only about seven percent of the capital presently in venture capital funds.[116] Basic economics tells us that such capital can be made up from elsewhere in the economy, as capital flows to its most profitable use.[117] In addition, investing in venture capital funds is a high risk activity with significant risk of loss.[118] The vast majority of banks have not traditionally invested in venture capital funds and overall are not major players in the venture capital arena. Rather than investing in venture capital funds, banks can and should issue loans directly to new businesses which they judge creditworthy.

To the extent that regulators feel it necessary to utilize their authorities under section 13(d)(1)(J), it may be acceptable to permit a bank that has not been declared systemically significant, is properly capitalized, and that acts in support of small businesses located in its geographic area of operation, to sponsor and hold in its longer-term investment book, investments in a fund of funds solely invested in third-party, local venture capital funds, as such terms are defined by the appropriate regulators. Such investments should be consistent with rules governing the maximum positions that a bank holding company can take in a non-bank company.

b. Permitted Fund Investments for Regulated Insurance Companies

As noted in the discussion above, section 13(d)(1)(F) provides for activities conducted within the general account of the insurance company. The reference to securities held in that account, rather than to proprietary trading, indicates the Congress intended to permit regulated insurance companies to continue to make investments as passive investors in third-party (not sponsored,

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[115] 76 Fed. Reg. at 68908 and 68915 (Question 278, 310 and 312).

[116] *See* Mary Dent, *A Rose By Any Other Name: How Labels Get in the Way of U.S. Innovation Policy*, 8 BERKELEY BUS. L. J. 128, 155 (2011).

[117] Also, some analysts believe that venture capital industry is undergoing fundamental change and may even be shrinking for reasons other than securities or banking regulatory efforts. *See* Bill Gurley, *What is Really Happening to the Venture Capital Industry* (Aug. 24, 2009), *available at* http://abovethecrowd.com/2009/08/24/what-is-really-happening-to-the-venture-capital-industry/.

[118] *See* John Cochrane, *The Risk and Return of Venture Capital*, 4 (Mar. 19, 2004), *available at* http://faculty.chicagobooth.edu/john.cochrane/research/papers/venture.pdf; Robert Hall, Susan Woodward, *The Quantitative Economics of Venture Capital* (Jan. 27, 2007), *available at* http://www.stanford.edu/~rehall/QEVC012707.pdf.

organized, or offered by the bank or its affiliates) hedge and private equity funds[119] as otherwise allowed under state insurance company law, provided that such activities do not become tools of evasion.

c. Permitted Fund Activities for Truly Foreign Banks

As noted in the discussion above, section 13(d)(1)(I) permits foreign banks to acquire an ownership interest in or sponsor a foreign fund, provided that no ownership interest in the fund is offered or sold to a U.S. resident. Similar to the comments regarding section 13(d)(1)(H), the purpose of this permitted activity is to advance international comity and allow foreign firms to engage in activities permitted under foreign laws, while reducing risk in U.S. banks and protecting U.S. financial stability.

One of the conditions to satisfying this foreign bank exemption is that "no ownership interest in such hedge fund or private equity fund be offered for sale or sold to a resident of the United States." The intent behind this requirement was "to maintain a level playing field by prohibiting a foreign bank from improperly offering its hedge fund and private equity fund services to U.S. persons when such offerings could not be made in the United States."[120] The provision also ensures that the activity remains truly foreign, and not is an activity conducted in the United States.

The provisions in the Proposed Rule implementing this statutory provision do a good job in faithfully implementing the law. In one respect, however, they appear to go somewhat beyond Congress' directive to level the playing field for investment management activities. The Proposed Rules would appear to prohibit foreign banks from placing capital in non-U.S. funds if those funds also accept capital from U.S. investors, even in situations where the foreign bank has no relationship with the non-U.S. fund other than as a purely passive investor. Covering such investments may extend the reach of U.S. regulations too far.

Nevertheless, a U.S.-based affiliate of the foreign bank should remain subject to the Volcker Rule and cannot make the same investment, as should be the case for any U.S.-based bank or foreign affiliate of a U.S.-based bank. The final rule should clarify, using carefully circumscribed language, that foreign banks may qualify for the permitted activities exemption to invest in a non-U.S. fund that they do not organize, sponsor, offer or sell, even if the fund's assets are ultimately commingled with assets of U.S. resident investors.

4. Merchant Banking

We are disappointed that, despite statutory authority, and clear expressions of Chairman Volcker's[121] and Congressional intent,[122] the Proposed Rule fails to explicitly restrict bank

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[119] The statutory text is designed to ensure that the Volcker Rule's prohibition on the sponsorship of a hedge fund and private equity fund not be evaded through ownership of an insurance company. It is not intended to limit insurance companies' abilities to make investment in unaffiliated entities that would otherwise be permitted under state insurance law.

[120] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[121] Tom Braithwaite, *Volcker Takes Aim at Long-Term Investments*, FIN. TIMES, Jan. 20, 2011, available at http://www.ft.com/intl/cms/s/0/2a03c58c-242a-11e0-a89a-00144feab49a.html#axzz1ml0T8O8T.

[122] *See* 156 Cong. Rec. S5894, S5895.

investments in merchant banking activities in the same manner as private fund investments, such as private equity investments. Merchant banking, which is the acquisition of equity ownership of non-financial companies, was recently allowed by banks as part of the deregulatory efforts of the past two decades. It is often largely indistinguishable from private equity activities, and exposes banks to similar risks, including conflicts of interest with respect to lending.

The Volcker Rule, and the Merkley-Levin Provisions that implement it, are intended to cover merchant banking. By remaining silent on these types of investments, the Proposed Rule invites circumvention of the statutory restrictions on investments in private funds. One way to rectify this situation would be to revise the definition of "trading account" to include accounts used for the acquisition of portfolio companies and other types of longer-term holdings. While the approach may vary, the result should be clear: merchant banking is covered by the Volcker Rule, was intended to be covered by the Merkley-Levin Provisions, and should be explicitly covered by the final rule implementing the law.

5. Sale and Securitization of Loans

Securitization abuses fueled the 2008 financial crisis that so damaged the U.S. banking system and economy. Done properly, securitization can transfer risk off of the balance sheet of a lending bank, and into the hands of investors willing to hold long-term exposures to interest rates and other risks. Done poorly, securitization can spread toxic assets throughout the financial system, concentrate highly correlated risks onto the balance sheet of a sponsoring institution, and become a source of conflicts of interest. The Volcker Rule seeks to permit plain vanilla, low-risk securitization activities, while preventing abusive practices.

The Volcker Rule addresses securitization in three ways. First, a bank may hold relevant assets in its trading account as part of an underwriting or in the course of market-making-related activities to serve clients. Second, a bank may obtain exposure through its sponsorship and equity ownership of an SPV used to securitize assets, because that SPV may be captured as a covered fund under the statute. Third, a bank may obtain exposure through its sponsorship and equity ownership of a hedge fund or similar fund that is involved in securitizations, holds asset-backed securities, or has interests in derivative products related to securitizations.

While the Proposed Rule contains a number of effective provisions related to securitization activities, it should be strengthened by: (1) treating all securitization activities as "permitted activities" subject to the limitations on permitted activities; (2) clarifying that the ban on bank bailouts applies to funds used for securitizations; (3) ensuring coordination with Section 621's prohibitions on conflicts of interest in securitizations; (4) barring bank involvement with highly complex securitizations that increase risk or render a risk analysis less reliable; (5) requiring higher capital charges for more complex securitizations; and (6) adding an anti-evasion provision to prevent securitizations from being used to circumvent the Volcker Rule's prohibitions.

Rule of Construction. At the request of community banks that did not engage in proprietary trading, statutory language was added to make it clear that the Merkley Levin Provisions did not interpret all securitization activities as forms of proprietary trading and would not prevent the sale or securitization of actual loans. This "comfort language" was included in Section 13(d) as

a "rule of construction," because it was not intended to establish a separate category of "permitted activity."

Nevertheless, the Proposed Rule, much like the FSOC report from January, effectively creates a new "permitted activity" for a class of securitizations, but unfortunately without also explicitly imposing the statutory limitations that apply to all other permitted activities.[123] We disagree with any view of the rule of construction as "inviolable" – that was certainly not our intent in creating the rule of construction – but do support the substance of the Proposed Rule's provisions authorizing a new permitted activity for some securitizations of loans. The provisions set reasonable, clear guardrails around the activity, emphasizing plain vanilla securitizations and providing clear boundaries for industry to comply with and regulators to oversee.[124] In particular, the Proposed Rule states plainly that the new permitted activity is limited to actual securitizations of loans.

Because the rule effectively treats these securitizations as a permitted activity, it should also make them subject to the data collection requirements and the limitations that apply to all permitted activities, including the prohibitions on high-risk assets and trading strategies, as well as material conflicts of interest.

Credit Risk Retention. The Proposed Rule also establishes a new permitted activity, under section 13(d)(1)(J)'s discretionary authority, for securitizations that meet the credit risk retention requirements of Section 941 of the Dodd-Frank Act. This part of the Proposed Rule is required to coordinate implementation with Section 941 of the Dodd-Frank Act, which requires banks to retain a portion of every securitization they sponsor.

Some have argued that the credit risk retention requirements in Section 941 essentially compel banks to engage in impermissible proprietary investments, since they are required to hold a portion of their securitizations over time. To address that concern, the Proposed Rule has reconciled the two statutory sections in a reasonable fashion. First, by making these securitizations a "permitted activity," the Proposed Rule eliminates uncertainty about their legal validity. It is also important to note that, because the securitizing bank is required under Section 941 to hold onto a portion of its securitizations over time, it is engaging in a longer term investment that should be carried in its long-term banking book, rather than its trading account, a point that the Proposed Rule should make explicit.

While Section 941 places a five percent floor on the credit risk that must be retained by a securitizing bank to encourage better quality securitizations, neither that section nor the Proposed Rule imposes any ceiling. As a practical matter, setting a ceiling may not be possible. During the financial crisis, for example, securitizing banks were sometimes forced to retain 100 percent of their securitizations due to a lack of interested buyers.[125] Because securitizing banks will retain some and perhaps all of their securitizations, this activity will continue to carry significant financial risks.

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[123] 76 Fed. Reg. at 68852, 68896, 68908, and 68912 (including Questions 78, and 296-301).

[124] Notably, this safe harbor for legitimate securitizations is limited to cash loans, limited derivatives, and other simple structures. 76 Fed. Reg. at 68912 .

[125] *See, e.g.*, PSI Report at 215-216, 241 (Washington Mutual); PSI Report at 283 (Countrywide); PSI Report at 286 (Indy Mac).

Because the Proposed Rule authorizes banks to engage in securitizations, the final rule should also address the issue of financial engineering techniques used to create extremely complex securitizations. During the financial crisis, some financial institutions created securitizations with complex tranches, convoluted payment schemes, synthetic features, and embedded derivatives. Some involved the re-securitization of securitized assets, resulting in such high risk, complex financial instruments as CDO-squared or even CDO-cubed.[126] These highly complex securitizations, with no reliable performance data or valuation, are far from the plain vanilla securitizations that community banks have traditionally conducted, and should not be afforded the special treatment of the rule of construction for securitizations of loans. The final rule should utilize the high risk asset limitations on permitted activities to bar any securitization by a bank from using complex structures, re-securitization techniques, synthetic features, or other elements that may increase risk or make a risk analysis less reliable. In addition, we recommend that the rule require regulators to impose higher capital charges for as complexity increases in securitizations.

In addition, since the credit risk retention requirement is designed to incentivize securitizing banks to issue higher quality securities with reduced risk, it dovetails with the risk-reducing objective of the Volcker Rule. Moreover, by utilizing Section 13(d)(1)(J) to authorize these securitizations, the Proposed Rule has ensured that this new permitted activity is subject to the limitations on permitted activities, in particular, the rules governing high-risk activities and conflicts of interest.

Bailout Prohibition. One area in which this part of the Proposed Rule should be clarified involves its application to securitization activities through private funds and SPVs. The use of Section 13(d)(1)(J) to create a new permitted activity does not, in any way, lift the statutory prohibition in Section 13(f) on banks bailing out private funds that they have sponsored. The final rule would be improved if it were to make that point explicitly in relation to securitizations conducted through SPVs or other funds.

Section 621. The final rule would also be strengthened if it explicitly acknowledged the additional provisions in Section 621 of the Dodd-Frank Act barring conflicts of interest by participatants in securitizations. Sections 619 and 621 were intended to work in tandem, and each should cross-reference the other.

Anti-Evasion Provision. A final consideration is that some types of securitizations, including managed CDOs, off-balance sheet SPVs, and synthetic securitizations, could function as hidden proprietary trading operations for banks.[127] Regulators will need to closely examine the securitization activities of banks to determine whether any involve the type of risks that the Volcker Rule is intended to prevent. That review can be conducted in the course of routine bank examinations. The final rule would also be strengthened if it explicitly prohibited banks from using securitizations to evade the ban the Volcker Rule's prohibition on proprietary trading.

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[126] *See* PSI Report at 42-44, 396-97.

[127] *See* Dunbar, *supra* (regarding in particular synthetic exchange traded funds and other structured products). *See* also Dunbar, *supra* (regarding how CDOs were originally conceived of as a proprietary trading activity).

VII. Limitations on Permitted Activities for Proprietary Trading and Covered Funds

One of the strongest features of the Merkley-Levin Provisions is the requirement that *all* permitted activities lose their permitted status if they involve or result in material conflicts of interest, give rise to a material exposure to high-risk assets or high-risk trading strategies, or otherwise undermine the safety and soundness of the bank or the financial stability of the United States.[128]

These statutory "limitations on permitted activities" serve as a backstop across the entire spectrum of permitted activities and are critical to achieving the Volcker Rule's objectives of reducing risk and prohibiting the conflicts of interest that damage investor confidence in U.S. financial institutions and markets. When it comes to implementing these statutory backstops, however, the Proposed Rule provides some strong general language, but offers very little guidance on how the prohibitions should be implemented. As mentioned earlier, Section 13(d)(2)'s limitations on permitted activities needs to be better integrated into the final rule to ensure that banks confine themselves to low-risk, conflict-free transactions.

To effectively implement the law, the final rule should: (1) eliminate provisions that allow conflicts of interest to be disclosed instead of ended or prevented; (2) detail how the broad definitions of "high risk assets" and "high risk trading strategies" would be used, in practice, to limit permitted activities, including by providing specific examples; and (3) require data collection and analysis to be included in routine bank examinations reviews to detect and stop high risk assets or trading strategies and conflicts of interest.

1. Conflicts of Interest

The Merkley-Levin Provisions contain an unambiguous prohibition on banks engaging in permitted activities that would involve or result in a material conflict of interest between the bank and its clients, customers, or counterparties. The Proposed Rule would implement this prohibition, not by requiring banks to prevent, avoid, and end such conflicts, but instead by requiring them to disclose the existence of such conflicts and create information barriers to prevent situations that could give rise to such conflicts. The Proposed Rule also raises several questions regarding the types of appropriate disclosures that may be required to address these types of conflicts.[129]

A disclosure-based regime, however, has no basis in the statute and is contrary to the plain language and intent of the Volcker Rule. There is no provision in the law for disclosure to sanitize conflicts of interest. Disclosure is too often boiler plate language or wrapped in technical obfuscations. The Merkley-Levin Provisions do not state a bank may engage in activities that result in conflicts of interest if the bank discloses those conflicts. The provisions prohibit engaging in those activities altogether.

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[128] 76 Fed. Reg. at 68892-96.

[129] For example, the Proposed Rule examines the potential role of oral versus written disclosures (Question 200), and one-time disclosures (Question 202), as well as whether certain types of customers may not need disclosures (Question 204). 76 Fed. Reg. at 68895. The Proposed Rule also offers a question on how to address circumstances in which disclosure may be impractical (Question 206). 76 Fed. Reg. at 68895.

These prohibitions are particularly relevant in the contexts of underwriting, market-making-related activities, risk-mitigating hedging, and organizing and offering a fund. For example, a bank underwriting a structured product made up of derivatives for which it serves as the counterparty has a conflict of interest. In another example, a bank that uses client information gained through market-making activities to select investments by a fund it organized and from which it profits has a conflict of interest. In both cases, disclosure is not a meaningful deterrent or cure.

This judgment was reached by Congress after uncovering the conflicts-ridden transactions that characterized much of the financial crisis. For example, the Permanent Subcommittee on Investigations examined Hudson, a $2 billion synthetic CDO referencing subprime residential mortgage-backed securities (RMBS) organized by Goldman Sachs in the fall of 2006.[130] The CDO was designed as an efficient method for Goldman to reduce its unwanted long positions in the ABX index and subprime mortgages. The assets Goldman selected for Hudson consisted of $1.2 billion in subprime RMBS that offset its specific ABX exposure and another $800 million in outright shorts of subprime RMBS. Goldman secretly held the entire $2 billion short side of the synthetic CDO. Goldman then recommended and marketed the Hudson securities to investors, selling them the long side of the CDS. Goldman also sold a $1.2 billion CDS to an investor, providing that investor with long exposure to the Hudson CDO.

Hudson's offering materials included vague and generalized risk factors, noting that Goldman "may" take a short interest in the CDO. The materials failed to inform investors that Goldman had already decided to take the short interest, and that the CDO was specifically designed to offset risky assets on Goldman's balance sheet and to produce profits as a result. A disclosure-based regime leaves the door open for continued abuse of the type of deceptive "disclosures" seen in Hudson and that would be difficult and expensive for regulators to police.

Another example involves Anderson, a $305 million synthetic CDO Goldman organized in 2007.[131] A majority of Anderson's referenced assets had been issued by subprime lenders which were known by Goldman for issuing poor quality loans. The largest single issuer was New Century which, during the time Anderson was being assembled, was being scrutinized by Goldman personnel for its poor quality loans. During the entire period in which Goldman recommended and sold the Anderson securities, it had a strongly negative view of the mortgage market in general, and New Century in particular. Goldman was also working intensively to remove mortgage-related assets from its balance sheet and was short 40 percent of the pooled assets in Anderson. In summary, at the time Goldman was marketing the Anderson securities to investors, it had a negative outlook of the entire mortgage market, a negative view of Anderson's largest issuer, New Century, a negative view of the specific assets in Anderson, and a financial interest in the failure of the CDO. Goldman disclosed that New Century was a major originator in Anderson, but did not disclose its extreme negative views of the firm. In fact, when an investor raised concerns about the New Century loans referenced in the CDO, Goldman personnel worked affirmatively to verbally dispel that investor's concerns. The Proposed Rule should not rely on a regime where formal, but inadequate, disclosure can be be further

[130] *See* PSI Report at 619-36.
[131] *See* PSI Report at 636-47.

undermined by verbal assurances that do nothing to cure the conflicts of interest that disadvantage investors.

By enacting the Volcker Rule, Congress rejected a disclosure-based regime for these types of serious conflicts of interest, in favor of a flat-out prohibition on banks engaging in material conflicts of interest. The Proposed Rule needs to be revised to comply with the law. It should state explicitly that banks may not engage in any activity that would involve or result in a material conflict of interest; that material conflicts of interest cannot be cured through disclosure; and regulators must take steps to determine whether banks are engaging in prohibited conflicts of interest during routine bank examinations. If regulators nevertheless decide to allow disclosures to address conflicts, then regulators should at least require that the disclosures be affirmatively and explicitly provided in writing and that the party receiving the disclosures acknowledge in writing that it understands and accepts the specific conflicts being disclosed.

To encourage compliance, regulators may also want to develop interpretive guidance setting out examples of material conflicts of interest, metrics that should serve as red flags warning of possible abuses, and any appropriate safe harbors. This guidance could accompany or follow issuance of the final rule.

2. High-Risk Assets and High-Risk Trading Strategies

The Proposed Rule also falls short in its efforts to implement the law's ban on high risk activities. It begins in a promising way, by defining high-risk assets and high-risk trading strategies as activities which "significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail."[132] This definition is appropriately broad, and flexible enough to be utilized by regulators in a variety of contexts.

It would be substantially improved, however, if the definition also encompassed assets and strategies that are so novel or complex that their risk or value cannot be reliably and objectively determined. This additional dimension to the definition is needed, due to the rapid evolution of increasingly complex financial instruments with no performance track record, no risk profile, and no easy way to evaluate or predict their financial consequences. These financial products include instruments with embedded contingencies, leverage, volatility, complex valuation methodologies, timing and liquidity risks, index tradeoffs, or other complexities. It should be noted that whenever novel or complex financial instrument are, in fact, deemed to be high-risk assets or to involve high-risk trading strategies, the Volcker Rule would not remove them from the marketplace; it would simply prohibit banks from partaking in offering them until other nonbank firms develop better performance track records and more reliable risk and valuation profiles.

Another weakness in the Proposed Rule is that it provides no guidance on how banks or regulators should implement the statutory ban on high risk assets and trading strategies. Banks and regulators need guidance on how to prospectively evaluate particular financial products and trading strategies as well as examples of what is prohibited.[133] Examples of high risk assets could include synthetic derivatives, products containing re-securitized assets, swaps involving

[132] 76 Fed. Reg. at 68894.
[133] 76 Fed. Reg. at 68896 (Question 214).

interests in novel indices, catastrophe bonds or related swaps, interests in offshore blocker corporations, and unrated products.[134] Examples of high risk trading strategies could include highly leveraged trades, trades using short-term loans to finance long-term debt, securitizing atypical assets, and trades involving the rehypothecation of substantial client assets.[135]

Again, labeling any of these products or strategies as high risk does not eliminate them from the marketplace; it only delays their use by banks until more information is developed on them. The final rule should also make it clear that reviews of assets and trading strategies to identify any that are high risk will be part of routine bank examinations. Again, safe harbors, presumptions, and additional guidance may be helpful.

Lastly, the Proposed Rule lacks any provision requiring or detailing how the data collection process detailed elsewhere in the rule will be used to enforce the Merkley-Levin Provisions' ban on high risk assets and trading strategies and material conflicts of interest. The data elements specified earlier, which include a variety of risk parameters, provide valuable tools to monitor, detect, and stop the high risk activities prohibited by the law. The final rule should make it clear that the data collection process will be used for that purpose, and provide additional guidance on useful risk metrics and parameters.

VIII. Limitations on Relationships with a Covered Fund

The limitations on relationships with covered funds (sometimes called "Super 23A" because they are a stronger version of the Federal Reserve Act 23A, which limits transactions between affiliates) were included in every version of the Merkley-Levin Provisions, because of the history of financial firms bailing out their funds and then needing bailouts by the taxpayers. These limits are important complements to the general limitations on organizing and offering funds, which are designed to limit the risks of bailouts to large financial firms.

The legislative intent of the statute allowing permitted services was to allow banks to offer permitted services only to third-party funds in which a fund organized and offered by the bank is invested. The Proposed Rule as currently drafted ignores that Congressional intent and should be revised to limit the services that banks may provide to only those for third party funds. The Proposed Rule also provides insufficient guidance regarding the definition of "prime brokerage," and how to distinguish this client service from impermissible trading activities. Nor does it clarify how the provision of those services does not give rise to some of the risks that the Merkley-Levin Provisions are designed to limit. The scope of the rule should reflect the intent of Congress and not be broadened.

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[134] *See* Omarova, *supra*, 1087-90.

[135] *See generally*, Jane D'Arista, *supra*; Dunbar, *supra*; Matthew Richardson, Roy Smith, Ingo Walter, *Large Banks and the Volcker Rule,* in VIRAL V. ACHARYA, THOMAS COOLEY, MATTHEW RICHARDSON AND INGO WALTER, EDS., REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE (2010); Satyajit Das, TRADERS, GUNS, & MONEY: KNOWNS AND UNKNOWNS IN THE DAZZLING WORLD OF DERIVATIVES (2006).

IX. Subpart D Compliance Program Requirements and Appendix C Minimum Standard for Programmatic Compliance

The Proposed Rule sets forth a reasonable compliance regime to implement the Merkley-Levin Provisions, requiring internal controls, record-keeping requirements that vary with the size of firms, and reporting requirements. Effective implementation of the Merkley-Levin Provisions would be enhanced, however, if the final rule were also to require: (1) banks to conduct annual management assessments of the effectiveness of their internal controls; (2) regulators to establish a centralized data repository to develop analyses of trading practices and risk profiles; (3) banks to provide increased public disclosure of each bank's trading activities, compliance metrics, and risk management procedures; and (4) regulators to establish clearer enforcement structures and penalties.

Internal Control Assessments. The Proposed Rule currently requires the CEO and the Board of the relevant bank to take responsibility for establishing and supervising implementation of the firm's internal controls and compliance policies to implement the Volcker Rule. It does not take the next step, however, of requiring a Sarbanes-Oxley-like annual management assessment of the effectiveness of those internal controls and policies.[136] It should. Such an annual assessment would not only ensure ongoing management attention, but also promote adjustments to firms' internal controls as financial instruments evolve and trading strategies change. A Board and CEO attestation of the adequacy of the internal compliance regime would ensure that senior bank management is personally involved with ensuring compliance with the rule. The Proposed Rule also does not require a public accounting firm to attest to the accuracy of those annual assessments.[137] The Proposed Rule would be much stronger and more effective if both those requirements were added.

Data Sharing. One weakness in this part of the Proposed Rule is its failure to include effective mechanisms to ensure consistent enforcement of the Volcker Rule across agencies and banks. The Proposed Rule does ask whether regulators should create a central data repository or share records, but does not require it.[138] Creating such a centralized data repository or data sharing protocol, as urged by Chairman Volcker and others, would go a long way toward promoting consistency and accountability in oversight and regulation across banking sectors. As mentioned earlier, the best candidate to take on this responsibility would be the Office of Financial Research (OFR), which has jurisdiction to examine all types of financial activity and whose mission is to collect and analyze financial data. OFR could then share its data compilations and analyses with individual regulators as well as the Financial Stability Oversight Council. To promote consistency and deepen financial analysis, the collected data should be made available upon request to any agency charged with Volcker Rule enforcement, even if not functionally regulating the firm. In addition, OFR or the FDIC could undertake to issue periodic internal bulletins or guidance on various issues to facilitate consistent regulatory oversight and enforcement of the Volcker Rule.

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[136] *See* Section 404 of the Sarbanes–Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (Sarbanes-Oxley Act). The Proposed Rule does faithfully implement the statutory requirement that a bank CEO certify that the bank is not guaranteeing ("bailing out") any fund organized and offered by the bank as a permitted activity for which the bank provides prime brokerage services. *See* 76 Fed. Reg. at 68916.

[137] *See* Section 404(b) of the Sarbanes-Oxley Act.

[138] 76 Fed. Reg. at 68921 (Question 337).

Increased Public Disclosure. Finally, the Proposed Rule does not currently take advantage of the compliance benefits that would arise from increased public disclosure of banks' trading and funds activities. Given the demands on regulators and the difficulties of overseeing global financial conglomerates, public disclosure offers a valuable and cost effective means to buttress compliance with the Merkley-Levin Provisions, by enlisting the help of often better-informed institutional investors and other public participants. Because banks are barred from proprietary trading and should be entirely engaged in client services, they should have greatly reduced proprietary interests against disclosing their trading activities. Thus, as a means to ensure that they are not engaging in proprietary trading, all of their trading positions, their valuation models,[139] and their compliance metrics should be fully disclosed to the marketplace on a delayed basis, perhaps by 90 or 180 days.

Fully disclosing these trading positions, valuation models, and metrics would enable institutional investors and other market participants, for the first time, to ensure that banks are not taking advantage of them. It would be a reversal of the current situation in which only large dealers get to see the trading flows of their customers and then use that data to their benefit. If a client were to detect trading positions over the prior quarter that suggested proprietary trading, high risk activity, or a conflict of interest, it could report its concerns to regulators. At a minimum, banks should be required to participate in all reporting systems that currently apply to securities broker-dealers, including the TRACE system for bonds.

Smaller Institutions. The Proposed Rule currently includes special provisions to facilitate compliance by community and regional banks that do not engage in any meaningful amount of proprietary or other trading activities. This accommodation of small financial institutions with limited trading activities represents a reasonable and cost effective way to minimize compliance costs and ensure compliance efforts are concentrated at the firms engaged in the types of trading that led to the Volcker Rule's restrictions.

X. Non-Bank Financial Companies Supervised by the Board

The Merkley-Levin Provisions were designed to respond to one of the major regulatory deficiencies uncovered by the financial crisis, the failure to address risks posed by systemically significant non-bank financial companies. While the focus of this letter has been on banks (which we have defined to include all "banking entities," as so defined by the statute), the Merkley-Levin Provisions apply to systemically significant non-bank financial companies as well, albeit through the tools of additional capital charges and quantitative limits. As the Proposed Rule does not meaningfully address them, we have reserved our comments in this area until the corresponding rules are proposed. We are disappointed that these firms were not addressed in the Proposed Rule, but also recognize the difficulties posed by coordinating application of the Merkley-Levin Provisions with respect to these firms with other provisions in the Dodd-Frank Act.

That said, the proprietary trading activities that led to the failure of firms such as Bear Stearns and Lehman Brothers were just as central to the financial crisis as activities at banks such as Washington Mutual and Citigroup. Because the largest investment bank broker-dealers are now

[139] *See* Gerding, *supra.*

part of commercial banks, the bank portions of the Merkley-Levin Provisions are that much more pressing. However, when systemically significant non-bank financial companies are designated, it should not be forgotten that the Merkley-Levin Provisions address both sets of financial firms. The failure of MF Global is ongoing proof that regulators cannot ignore risks that may emerge from non-bank financial companies. Regulators have been working on designing appropriate criteria to identify nonbank financial firms that are systemically significant and should move soon to identifying those firms. When those firms are identified, the Merkley-Levin Provisions will apply to them as well through capital charges and quantitative limits.

The use of capital charges is intended to permit nonbank financial institutions to continue to engage in their normal activities, but to the extent a firm may become systemically significant, to curtail the risk posed to the system by invoking additional capital charges and quantitative limits which grow increasingly restrictive as the firm becomes more systemically important. The most fundamental principle is that as firms become more systemically risky, the Merkley-Levin Provisions should act to constrain their activities as if they were banks.

Currently, the Proposed Rule does not set forth any guidance or indication as to how capital charges will be assessed on nonbank, systemically significant firms. The final rule deals only with banks. Additional guidance is needed on application of the Merkley-Levin Provisions to systemically significant non-bank financial companies.

XI. Implementation Timing

Section 13 goes into effect no later than two years after its enactment into law, whether or not regulations have been finalized. That deadline, in July 2012, is fast approaching. We urge regulators to act as quickly as possible to provide needed clarity to market participants and confidence to investors and the public. Delay does not serve anyone's interest.

CONCLUSION

The objectives of the Volcker Rule, as embodied in the Merkley-Levin Provisions, have long been clear: to reduce the risks and conflicts of interest that accompany unrestricted proprietary trading and relationships with private funds. The Volcker Rule is intended to provide a 21st century version of the Glass-Steagall Act that served our economy – and financial system – so well for over 60 years.

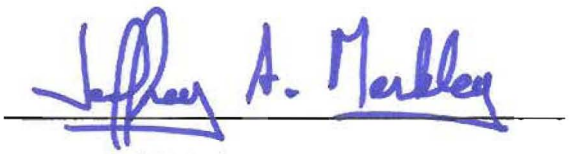
The Volcker Rule demands Wall Street change its culture. Implemented in a smart, vigorous way, the Volcker Rule can both protect the U.S. economy and taxpayers from some of the gravest risks created by the nation's largest financial institutions, while providing plenty of space for these financial institutions to provide the plain vanilla, low-risk, client-oriented financial services that help the real economy grow.

The Volcker Rule will not protect against every risk, nor can it work in a vacuum, apart from other critical reforms found in the Dodd-Frank Act, such as the Consumer Financial Protection Bureau, resolution authority, derivatives reform, and capital reforms. But it must be an essential pillar of stabilizing our financial system, and ensuring its ability to support the U.S. and world economy for decades to come.

The Merkley-Levin Provisions should be interpreted as broadly as Congress intended—and our country needs. With needed clarifications and improvements, the Proposed Rule represents an important step forward in changing fundamental culture and operations of our financial system. The final rule should not shy away from that task, but should embrace this opportunity to reduce risks and end conflicts of interest that helped cause the financial crisis from which we are still recovering.

Thank you for this opportunity to comment on the Proposed Rule.

Sincerely,



Senator Jeff Merkley

Senator Carl Levin