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EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES, INVESTORS AND JOB CREATION, PART II

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

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CONTENTS

	Page
Hearing held on:	
December 13, 2012	1
Appendix:	
December 13, 2012	45

WITNESSES

THURSDAY, DECEMBER 13, 2012

Barth, James R., Lowder Eminent Scholar in Finance, Auburn University; Senior Finance Fellow, Milken Institute; and Fellow, Wharton Financial Institutions Center	9
Hambrecht, William R., Chairman, WR Hambrecht + Co.	11
Kelleher, Dennis M., President and Chief Executive Officer, Better Markets, Inc.	13
Plunkett, Jeffrey, General Counsel and Executive Vice President, Natixis Global Asset Management, on behalf of the Association of Institutional INVESTORS	15
Quaadman, Thomas, Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce	16
Stevens, Paul Schott, President and Chief Executive Officer, the Investment Company Institute (ICI)	18

APPENDIX

Prepared statements:	
King, Hon. Peter	46
Barth, James R.	47
Hambrecht, William R.	55
Kelleher, Dennis M.	62
Plunkett, Jeffrey	81
Quaadman, Thomas	125
Stevens, Paul Schott	137

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Frank, Hon. Barney:	
BreakingNews article entitled, "Too big to fail looks on its way to being licked," dated December 13, 2012	161
Hayworth, Hon. Nan:	
Written statement of the American Council of Life Insurers (ACLI)	162
Written statement of BBVA Compass	165
Written statement of the Bond Dealers of America (BDA)	172
Written statement of the Institute of International Bankers (IIB)	177
Miller, Hon. Brad:	
Public Citizen report entitled, "Business as Usual," dated December 2012	180

EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES, INVESTORS AND JOB CREATION, PART II

Thursday, December 13, 2012

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 9:01 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the committee] presiding.

Members present: Representatives Bachus, Hensarling, Royce, Capito, Garrett, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Hayworth, Renacci, Hurt, Dold, Schweikert, Canseco, Stivers, Fincher; Frank, Waters, Maloney, Watt, Meeks, Capuano, Baca, Lynch, Miller of North Carolina, Green, Cleaver, Perlmutter, Himes, and Carney.

Chairman BACHUS. Good morning. We started this hearing at 9 a.m., instead of 10 a.m., because we didn't want votes to interrupt what we consider to be a very important hearing. The hearing will now come to order.

As previously agreed with the ranking member, there will be 10 minutes on each side for the purpose of making opening statements. And without objection, all Members' written statements will be made a part of the record, as well as the witnesses, your entire statements will be made a part of the record.

I recognize myself for 5 minutes for the purpose of making an opening statement. This morning, the committee holds its second hearing focused exclusively on the Volcker Rule and, specifically, its impact on the markets, investors, and job creation. [The first hearing was held on January 18, 2012. Serial No. 112–95.] The Massachusetts Educational Finance Authority has warned regulators in its comment letter of February 13th that the Volcker Rule would increase funding costs for the authority's bonds, which "would be passed along to consumers funding higher education expenses through their loan program."

In a February 14th comment letter to regulators, the Financial Executives International, which represents corporate treasurers of both public and private companies, wrote that the Volcker Rule as proposed could adversely affect the ability of American businesses to grow, create jobs, and contribute to healthy economic recovery.

Putnam Investments also cautioned regulators in their comment letter that the consequences of the Volcker Rule "may range from

reduced liquidity in U.S. capital markets in harming their global competitiveness to raising the cost of capital to U.S. corporations, lowering returns to investors, and curbing the American economy's capacity to grow."

The Volcker Rule is designed to prevent proprietary trading by banks. But no one, not even Paul Volcker himself, argues that proprietary trading was a cost of the financial crisis. The erosion of lending standards and the Federal Government's poorly conceived efforts to subsidize mortgage lending caused the financial crisis, not proprietary trading. Therefore, the Volcker Rule sticks out as an oddly considered afterthought, a solution in search of a problem.

Even if one attempted to argue that proprietary trading played a role in causing the financial crisis, and even if banning proprietary trading would make the financial system safer—propositions, by the way, that are simply not supported by the evidence—the prospect that regulators have been unable to agree on a single version of the Volcker Rule is extremely troubling.

Competing versions of the Volcker Rule will make it all the more difficult for market participants to know what their obligations are and how to comply with them, particularly if they find themselves subject to conflicting obligations enforced by different regulators. The Volcker Rule, or even worse, rules, will not make the financial system any safer. But as I said, it will impose significant costs on consumers, workers, savers, students, taxpayers, and businesses.

It will stifle the growth of businesses that operate far from Wall Street, and it will hamper the ability of asset managers, pension funds, and insurance companies to grow the value of their portfolio for millions of individual investors, or retirees. The Volcker Rule is a self-inflicted wound that should be repealed. Unfortunately, the 112th Congress did not do that. Hopefully, the 113th Congress will do so.

I thank all of the witnesses for being here today to offer their perspectives, and I look forward to the discussion we will have on this important topic.

At this time, I recognize the ranking member for his opening statement.

Mr. FRANK. Thank you, Mr. Chairman.

I will yield myself such time as I may consume, because I want to consult with my colleagues about their time. I will say that this is a very important subject, but not all of the Members are at this point in the spirit of full participation in the legislative process. That means no disrespect to those who have honored us by coming here this morning.

I want to talk about the Volcker Rule in the context of the broader question of bank regulation. I understand my colleagues on the Republican side, this is part of their general approach, that very little needs to be done after the financial crisis of 2008 and 2009, and I am particularly struck by what seems to be great inconsistency. Many of the Republicans, some of the critics of our legislation, have complained that we didn't do anything about the too-big-to-fail doctrine, quite contrary to the written language. And some have said, well, maybe the banks are too big. The argument is, as long as they are as big as they are, probably too-big-to-fail is inevitable. One of the things that has been proposed that I believe will

go into effect to reduce the size of the banks is the Volcker Rule, and it does it, I believe, in a thoughtful way.

It reduces them not by some arbitrary order by the government to sell things off, not to create a fire sale of financial assets, which I think would be the result of some of the demands that they simply reduce; it does so in a functional way.

Now, I do want to address the notion that this will put us at a competitive disadvantage. To some extent, my friends in the financial institutions have taken as their model the 14-year-old child of divorced parents, who thinks they can play mommy against daddy and get a great deal more freedom in their minds.

When I hear Americans talk about how restrictive the Volcker Rule will be, it sounds like what the British are telling the British authorities about ring-fencing. In fact, I think there was a good deal of coordination and I doubt very much that we are going to be far in advance, for instance, of the British or even the EU with regard to this kind of separation. It is simply an effort to, as I said, play one against the other. It is a functional way to reduce.

And I want to address this because it is a question I want to ask some of my friends when they say that we have not dealt with too-big-to-fail appropriately. The Volcker Rule in context is one of the ways to do this. And I was particularly moved to say that by an article in Politico yesterday, which is in many ways as close to 100 percent inaccurate as it is possible linguistically to get. And I believe I have complied with the Rules of the House in saying that. For example, it begins—and this is not one of my colleagues—the author says, the government's decision to bail out AIG in 2009—wrong by a year and a critical year. In 2009, Barack Obama was President. In 2008, when AIG was bailed out, it was bailed out by the unilateral decision by the Federal Reserve with the full concurrence of the Bush Administration. It was under Section 13.3 of the Federal Reserve Act.

Mr. Bernanke and Mr. Paulson, I mean no criticism of them; I think they behaved very well during this. Many of us on the Democratic side were more supportive of the crisis efforts of President Bush and his aides than my Republican colleagues. And it was an example of full bipartisanship. I have to say a month before the 2008 election, the Bush Administration got complete cooperation from the Democrats here in dealing with the crisis. But Mr. Bernanke and Mr. Paulson came to us and informed us that they had decided to advance—Mr. Bernanke did under his statutory authority—$85 billion to AIG. It had nothing to do with TARP. It had nothing to do, obviously, with subsequent legislation. It was a decision made by the Federal Reserve.

And then, I note, some of my Republican colleagues were saying, this is an example of a problem with too-big-to-fail and the legislature's failure to address it. As a matter of fact, the authority under which Mr. Bernanke unilaterally gave, lent—because they got the money back—$85 billion to AIG has been rescinded. The statutory authority, Section 13.3, was repealed. So, in fact, the bailout of AIG, that process, was made illegal by the Act; exactly the opposite of the suggestion that somehow the Act embodies this.

The Act goes further and it says that if a financial institution gets in trouble, it can be resolved, and there may even be a pay-

ment of some of the debts if that is felt necessary—that, by the way, suggested to us by Mr. Paulson in particular—but only as part of dissolving the institution. And we have this extraordinary proposition from some that says if a bank gets into trouble, a very large institution—and my colleagues, while they say we haven't done enough about some of this too-big-to-fail, oppose almost everything we propose that would reduce their size and make them less of a problem. The Volcker Rule, has, I believe, an operational and sensible way to reduce the size by removing some of the functions in a way that I think is less disruptive than any other alternative, a required sale, et cetera. But what we are told is that if a large financial institution gets in trouble, somehow, in some parallel universe, a Secretary of the Treasury would feel political pressure to give Federal money to bail them out and keep the institution alive, despite the fact that would be a violation of Federal law and despite the fact that politically, it would be exactly the opposite. All of the pressure would go the other way.

Now, obviously, there are still problems with the large institutions. Although I note in an article—I will have to get the article and put it in the record—that the investment community is starting to price down what they give the large financial institutions. It is from BreakingViews, and I would ask unanimous consent to put it into the record. It is entitled, "Too big to fail looks on its way to being licked," and talks about the market finally trying to price in the fact that the law clearly states that no large financial institution can receive assistance except as part of its death sentence.

The final point I would make is about the complexity of—oh, yes, there was an article, a complaint in February about the handling of some bonds. I believe it will be resolved, but the final point is this: When the Volcker Rule was first proposed, many in the financial community asked that it take into account this, that, and the other. There has been an effort to try to accommodate this, and now that is being used against the people who have listened to some of those comments by saying, you make it too complicated.

I believe it is important that it get done this year. I believe it will be. And I think you will see a Volcker Rule that will be adopted uniformly, that will be reasonable, that will not put Americans at a competitive disadvantage. And Iwill make a prediction. One of the things that frustrates me is that people are able to make all kinds of criticisms of all sorts of things, secure in the knowledge that 2 and 3 and 4 years later, when the criticisms have been proven to be unfounded, no one will remember what they said. So I hope that the media here will not just chronicle what is said, but will put it somewhere where you can retrieve it and, in a couple of years from now, see how unfounded all of these dire predictions have been.

How much time did I consume, Mr. Chairman?

Chairman BACHUS. Thank you.

Mr. FRANK. How much time did I consume?

Eight minutes? Thank you.

Chairman BACHUS. Before recognizing the new chairman of the full committee, I wanted to say that Chairman Frank and I have not always agreed on the issues before the committee, or even before Congress, but I believe at all times we have strived to conduct

business in a civil manner and to be civil toward one another, and I compliment him on that. We try to disagree without being disagreeable. And while we have not always succeeded in that, it has not been from the lack of trying.

I very much enjoyed my association with him both when he was chairman and when he was the ranking member. And this is the ranking member's last hearing as a member of this committee, unless we schedule another hearing.

Mr. FRANK. You were getting people's hopes up, Mr. Chairman, when you said that.

Chairman BACHUS. But Chairman Frank has served with distinction for 3 decades. And I know all of my colleagues join me in wishing Congressman Barney Frank all the best as he moves forward on to other challenges.

At this time, I would like to give you a round of applause.

[applause]

Mr. FRANK. Thank you, Mr. Chairman, and—

Chairman BACHUS. I recognize you.

Mr. FRANK. I appreciate that, and I join in your sentiments that we have worked together without legitimate profound differences becoming personal.

Let me just take a second and say that one of the things that bothers me is this—you never heard the word "partisan" used in a group sense. And partisanship is essential to democracy. You don't have self-governance by large numbers of people without political parties. Otherwise, you descend into all kinds of purely personal things.

The problem with partisanship is not that it exists because there are legitimate differences that should be debated. The problem is when the differences that are legitimately recognized in a partisan alignment become so personally embittering that cooperation is impeded elsewhere.

And I thank you, Mr. Chairman, because that has never happened under your chairmanship, and I am very pleased that we have been able to do that.

As you said, we have tried to agree without being disagreeable. That hasn't always come naturally to me, but I have worked hard at it, and I think that, in the end, that has been the result. So I thank you for that consideration, and I look forward to sitting out there and watching you guys in the future.

Chairman BACHUS. Thank you. And this committee has, with the good work of both the Minority and the Majority—no matter which party was in what position—produced some very good legislation; a lot of legislation that has passed by over 400 votes, some of which has been adopted into law, and worked very well. We have two bills over in the Senate now, the FHA bill and the flood insurance bill, both passed by over 400, and I understand that the Senate may pass one of our bills today.

So I applaud Members on both sides. I think this committee sort of stood out as being able to work in a bipartisan way through some very difficult challenges. At this time, I would like to recognize the new chairman of the committee come January, Mr. Jeb Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman, and—

Chairman BACHUS. For 3½ minutes or whatever you want.

Mr. HENSARLING. I like the "whatever-you-want" part of that. With the indulgence of our guests and our witnesses, Mr. Chairman, I wish to add my voice into this moment of respect and admiration. I suppose, selfishly, one day I will be an ex-chairman, and I hope somebody chooses to say something nice about me and note my passing.

So today, even though, Mr. Chairman, we may, given the progress of the talks in the so-called fiscal cliff, be hanging our stockings next to the chimney with care next to our colleagues, or celebrating the New Year with them, I sense this is the last hearing of this committee in the 112th Congress. And as the incoming chairman of the committee, I would be remiss if I did not note that this will be the last hearing for two chairmen who have loomed large in this committee's history: one leaving not only the committee but Congress; and the other one stepping down as chairman.

First, to ranking member, then Chairman Frank, few have left a mark on this committee quite like he has. Few have brought into this room and into its proceedings an intellect as keen or a wit as clever. I will personally miss our spirited debates, not quite enough to ask him to reconsider and stay, but when I think in terms of how it is often challenging to say kind things about one in the opposing party. I believe passionately in the ideas that I bring into this committee room. And I have the greatest respect and admiration for those who also bring passion and sincerity to their cause in their debate, and certainly, Chairman Frank has done that.

And as a Member of the other party, who has opposed him vigorously for years, as chairman, he always conducted the proceedings in this room with fairness and his word was always good. And so I know, although we will say goodbye to him today in the Financial Services Committee, I sense that his presence will loom large some day soon, perhaps over my right shoulder or left shoulder. I am sure some competent staffer will one day tell me how these portraits work. And I guess I perhaps look forward to the day where I see more of him and have to debate him less.

Chairman Bachus, you are the epitome of a gentleman. You have brought into your style of leadership great kindness, humility, and integrity, and particularly those on our side of the aisle, who are fond of quoting President Reagan, who said, "There is no limit to what a man can do or where he can go if he doesn't mind who gets the credit." You have also embodied what President Reagan said. You have empowered Members. You have led by example, and you have taught us all—my 9-year-old son, who takes karate lessons back in Dallas, Texas, as part of an oath he recites, he talks about character. And he is defining to me, his old man, that character is doing the right thing when no one else is watching. And Spencer Bachus, our chairman, has character because he has always done the right thing.

Mr. Chairman, we will continue to benefit, fortunately, from your wisdom, your counsel, and your leadership, as you soon will take your status as chairman emeritus in this committee. So, again, I look forward to the day where I have one portrait over one shoulder, the other portrait over the other shoulder, but know some-

where down the way, you are also there to provide the counsel, wisdom, leadership, and character that you always have.

And with that, Mr. Chairman, even though the topic at hand is terribly important, I will allow other Members to address it in their opening statements, and I yield back.

Chairman BACHUS. Thank you.

Mrs. Capito?

Mrs. CAPITO. Thank you, Mr. Chairman.

I would like to thank you for convening this morning's hearing, and this will be the last time, as we have heard, that my good friend Spencer Bachus will be chairing this committee, and I also want to thank him.

And I want to thank the ranking member for his leadership, not just in this committee, but in our Nation. He has taken me down a few pegs every now and then, so I have enjoyed that—sort of.

Anyway, I am going to talk about the subject at hand. The majority of the focus on the implementation of the Volcker Rule has been on the effect it will have on Wall Street's ability to conduct trading activities. Less attention has been paid to the effect that the Volcker Rule could have on Main Street financial institutions and the businesses they serve.

Earlier this year, the Financial Institutions and Consumer Credit Subcommittee held a field hearing in Mr. Renacci's district, in Cleveland, Ohio. One of the witnesses at our hearing was a representative from KeyBank, a regional bank based in Cleveland. KeyBank raised significant concerns about the effect compliance with the Volcker Rule will have on their ability to meet their client's liquidity needs. Specifically, their institution is concerned that market-making activities and less liquid securities that are demanded by their clients could be construed as proprietary trades.

Regional banks like KeyBank are serving small- and mid-sized businesses across this Nation. If they cannot rely on their local and regional financial institutions to provide liquidity, they will not be able to help our economy grow.

We have also heard concerns from the regional banks about the substantial cost, both monetary and man-hours, or I will way woman-hours, involved just to prove that their market-making activities are not proprietary. These institutions are not the ones engaged in the activities the proponents of the Volcker Rule are seeking to address.

The regulatory agencies must ensure that the final rule addresses these concerns so small business and regional financial institutions are not adversely affected.

And I yield back. Thank you.

Chairman BACHUS. Thank you.

At this time—

Mr. FRANK. Thank you, Mr. Chairman.

I talked longer than normal because people weren't here, and then I offered time to my colleagues, who have really very graciously refused it and yielded it back to me. And I don't want to take up too much of your time, but I did want to address a couple more things on the Volcker Rule.

I understand the difficulty, but I do want to say, in defense of the regulators, that they are, to some extent, damned if they do

and damned if they don't. If they were to go ahead with a proposal generated among themselves, put it out there for comment, and then adopt it substantially unchanged, they would be legitimately criticized for not listening to the people who had good input.

When, as they now did, they listen to a very large number of comments, and seek to deal with them, and move the rule, then people complain that it is taking too long, et cetera.

I think the amount of time we are talking about is not too long, given the importance of this and of doing it right. I also believe that the fears that have been expressed, and I understand these, but I think they are without basis, that some institutions, because of the complexity of this when it is finally done, might inadvertently find itself in trouble; I do not believe we will ever have in this country financial regulators so bloodthirsty that they would fall on an innocent mistake excessively. In fact, I think it is hard to look at the record of enforcement from both parties over all the time and find any hanging judges in the midst.

Clearly, there will be a recognition that this is experimental to some extent, that it is new. I am sure, and I will certainly be critical if it isn't the case, that there will be the kind of forbearance, and that, in fact, what the regulators will appropriately do as we go forward with this is to say, in some cases, no, that is not what you should have done, and there will be no penalty for it, obviously exempting cases that were egregious and willful abuse; there will be no penalty, but do it differently in the future.

And as I say again, I would reiterate, there is a complaint, including from some on the Republican side, and many on the Democratic side, in the commentary community that the banks are just too big. I challenge people. The Volcker Rule is one way to diminish their size. And it diminishes it in a logical and functional way, and it is one that is being dealt with by other countries. If you reject the Volcker Rule, if there was to be no restriction of this sort and you still believe the banks are too big—I read this stuff very diligently up to now. Come January, I am going to forget an awful lot. My theme song, taken from the old anti-war days, is, "ain't going to study derivatives no more."

But up till now, I have read this, and I have not found any alternative, serious, thoughtful way to reduce the size of the large banks. And I believe it is inconsistent logically and bad policy to complain that these large financial institutions are too large, to oppose the Volcker Rule and to propose no alternative means of reducing their size.

And Mr. Chairman, to you and to all of the members of this committee, I am very appreciative for the great and generous tolerance of me in all of my facets that we have had, and I am very proud to have served here.

And I just want to close, if I can unanimously ask for another 30 seconds. In addition to the Members, can I say of the staff on both sides, I don't think the American people understand what a great bargain they get in the people who are talented, and dedicated, and creative, and who work for us at a lot less money, with harder hours, and not the best working conditions than they could get anywhere else.

And we have alternated. We have been in the Majority and the Minority. In the Majority, you get pretty good quarters. All of our staffs have been in the Minority, where the quarters are not so hot.

So I do want to close, as I acknowledge the generosity of my colleagues, to express what I know everybody agrees with, the enormous debt, not just the Members owe our combined staffs, but what the American people owe them.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you, and let me just take 15 seconds—last night, we had our Republican staff Christmas party that I have had every year. We had 86 staffers and former staffers. Several of them who were no longer staffers said, "I would love to still be on the Hill, but I couldn't turn down an offer," and in almost every case, it was for twice as much money. And some of them said, "I had children going to college; I just had to do it." But what a talented group we have here on both sides, and they work very well together. And I know that will continue, or I pray that it will. At this time—

Mr. FRANK. Mr. Chairman, can we get a round of applause for the staff?

Chairman BACHUS. Yes.

[applause]

All right, well deserved. At this time, I will introduce the panelists. The first panelist is Professor Jim Barth, who is the Lowder Eminent Scholar in Finance at Auburn University and Senior Financial Fellow at the Milken Institute. Some of you may not be familiar with Auburn, but you could consider it either the Yale of the South, or the Stanford of the East, I guess. But I went there, so that is why I made that remark. It is a very fine school. And Jim, it is great to have a friend testifying this morning.

Mr. William Hambrecht is the founder, chairman, and chief executive officer of WR Hambrecht + Co. And we welcome your attendance.

Mr. Dennis Kelleher is the president and CEO of Better Markets. And we welcome you back to the committee.

Mr. Jeff Plunkett is the general counsel and executive vice president of Natixis Global Asset Management, testifying on behalf of the Association of Institutional INVESTORS; Mr. Thomas Quaadman is the vice president of the Center for Capital Market Competitiveness at the U.S. Chamber of Commerce; and Mr. Paul Stevens is the president and CEO of The Investment Company Institute.

Welcome, gentlemen.

At this time, Professor Barth, you can proceed with a 5-minute opening statement.

STATEMENT OF JAMES R. BARTH, LOWDER EMINENT SCHOLAR IN FINANCE, AUBURN UNIVERSITY; SENIOR FINANCE FELLOW, MILKEN INSTITUTE; AND FELLOW, WHARTON FINANCIAL INSTITUTIONS CENTER

Mr. BARTH. Thank you.

Chairman Bachus, Ranking Member Frank, and members of the committee, thank you for the opportunity to testify today on the Volcker Rule. My opinions are based on my experience as an aca-

demic studying financial institutions and markets and as an official at bank regulatory agencies. I am now on the faculty of Auburn University and previously was on the faculty of George Washington University.

In addition, I have served as Director of the Office of Policy and Economic Research, of the Federal Home Loan Bank Board, and Chief Economist of the Office of Thrift Supervision. I have also held positions as visiting scholar at the Congressional Budget Office, the Federal Reserve Bank of Atlanta, the Office of the Comptroller of the Currency, and the World Bank.

In my scholarly research and government service, I have studied the performance of hundreds of financial institutions, including the causes of distress of many that failed. I believe the Volcker Rule is based on an incorrect premise, will be extremely difficult to implement, and, worse, will produce harmful economic effects.

There is no evidence to support the belief that proprietary trading was the cause of the recent or any other financial crisis. In fact, all of the evidence points to the contrary.

The most recent crisis was triggered by poor lending and underwriting practices in the real estate sector and excessive leverage by and insufficient liquidity at banking industries, not by proprietary trading by banks.

The implementation of the Volcker Rule will require regulators to distinguish between prohibitive proprietary trading and permissible activities, such as market making, hedging, and underwriting. Because these permissible activities sometimes appear similar to proprietary trading, it may be virtually impossible for regulators to draw a bright line between the prohibited and permissible activities that are not arbitrary.

To the extent that regulators err on the side of restricting beneficial trading activities or that the regulation deters banks from engaging in some permissible activities, the result will be banks providing less liquidity in the market. This, in turn, will increase the bid-ask spread on securities. Issuers will pay higher interest rates to raise capital, and investors will pay more to purchase securities and receive less when selling them.

All of these developments harm markets, businesses, investors, and job creation. As banks are denied the opportunity to engage in profitable trading activities, they may be driven to engage in evermore risky activities in an attempt to provide investors with an acceptable return. The Volcker Rule may, therefore, lead to riskier, not less-risky banks. The rule may also place U.S. banks at a competitive disadvantage to banks in other countries.

In addition, if proprietary trading simply carries on at nonbanks, the question then becomes, is the forced migration of proprietary trading from banks to nonbanks more likely to increase or decrease financial stability? To address this issue, I recently conducted a preliminary examination of 22 years of individual trading losses of at least $1 billion each. These trading losses were in no way limited to banks or financial services firms; rather, they occurred at a range of firms, including banks, investment banks, hedge funds, and manufacturing firms. Even a local government authority was involved.

Specifically, for the period of 1990 to 2012, the banks' losses were 5 percent of their equity and posed relatively little risk to solvency. Investment banks had losses equal to 34 percent of equity. Manufacturing and petrochemical firms, firms that are typically end users of derivatives and other financial products, had losses of 48 percent of equity. Finally, the most risky are hedge funds, which experience losses equal to 140 percent of equity.

These illustrative results suggest that trading appears to be less risky when carried out at banks than at nonbanks. The important point of this exercise, however, is that one should not focus on trading losses, per se, but on potential trading losses relative to equity capital, which reflects a firm's ability to absorb losses. Excessively leveraged firms are clearly less able to absorb trading losses, or any losses for that matter. Moreover, some large trading losses did occur during the final crisis, but mortgages based on poor lending and underwriting quality were largely to blame, rather than the trading itself.

The focus of regulation should, therefore, be on ensuring that banking entities have sufficient capital commensurate with risk, not on separating some investment banking activities from commercial banking.

In conclusion, I see very little, if any, upside to the Volcker Rule, but substantial cost to markets, businesses, and investors. That the rule is well-intentioned, and banks may survive it, is not the issue. The issue is whether the benefits exceed the cost. There is no evidence that this is the case, and my reading of the evidence is to the contrary. It is therefore difficult to justify such a major organizational change. Thank you very much.

[The prepared statement of Professor Barth can be found on page 47 of the appendix.]

Chairman BACHUS. Mr. Hambrecht?

STATEMENT OF WILLIAM R. HAMBRECHT, CHAIRMAN, WR HAMBRECHT + CO.

Mr. HAMBRECHT. Thank you, Mr. Chairman.

I was a member of the Investor's Working Group, an independent task force sponsored by the CFA Institute and the Council of Institutional Investors. It was chaired by two former SEC Chairmen, Arthur Levitt, Jr., and William Donaldson. Our report concluded, if I may read the quote, "Proprietary trading creates potentially hazardous exposures and conflicts of interest, especially institutions that operate with explicit or implicit government guarantees."

We came to that conclusion after a lot of debate and a lot of looking at what actually happened. And we thought our charter was, first of all, to try and figure out why the six largest banks were suddenly in trouble. How did that happen in an environment where, for almost 70 years, from the Glass-Steagall Act, there had been no crisis of that magnitude, nor had it fallen on the banks? There were a lot of trading losses. There were a lot of—we went through all different kinds of market cycles, but why did this happen?

There was a difference of opinion within the committee, and I am just giving you my opinion now, because I was designated to be the spokesman for this particular issue. And in my mind, the basic

issue, as it is in almost every major breakdown in the marketplace, is one of leverage. If you look at the market for mortgage paper, yes, you can say, gee, this was a terrible market. If you look at the Shiller-Case index, the real estate market went up about 20 percent in 2004; declined back down to about even; and then in the 2008–2009 marketplace, declined 20 percent. So it was a major move, but the kind of moves in markets that we have had countless times. And the thing that really created the crisis, in our opinion, was excessive leverage.

Where did this excessive leverage come from? And the question we kept asking the CFOs and the people who ran these companies was, hey, what banker in his right mind would lend you $0.97 on the dollar against an opaque piece of paper that is hard to understand, that is traded in a market dominated by the guys who create the paper? Who would do that? And frankly, the answer was, no one would do that. And the huge leverage, the $700 billion trading position at Lehman Brothers was basically financed with customer deposits in the form of free credit balances, most of them from short sales of hedge funds, and also from a repo market; that basically you borrow in the evening and you pay it off before the market opens up. So there won't be any real liquidity.

We focused on, first, how do you create a market that will truly reflect price discovery, cannot be dominated by a few people, and propping up prices that don't hold up? And then, second, how do you regulate the lending to these trading accounts when there is no lending discipline, when they make the decision as to how much money that can come because the customer base doesn't know about that?

We arrived at basically a conclusion that there had to be regulation, that it had to focus on functionality as former Chairman Barney Frank said, but it should also focus on the leverage factor, and how do you control that leverage?

So we came out with a recommendation that it be included in whatever regulatory framework would evolve out of this crisis, but that it focus, as the Glass-Steagall Act did, on leverage and control of leverage, so that when we do hit these inevitable market declines and excesses, the Fed and other people can control the amount of leverage that is inherent in the business.

My statement—I could go through it in great detail, but I will say there is some detail on the mechanics of how it works because we found that very few people really understood where the money came from. Investment banks' balance sheets are remarkably opaque. It is very difficult to understand where the money comes from. So I apologize for the technicalities in the paper, but they are based on a career of over 50 years in raising capital and dealing with traders and dealing with trading departments. And I find there are certain characteristics of trading departments and traders that seem to reoccur in every kind of market.

And the committee and, of course, as many of us did, focused on how do you separate, or how do you determine what is a proprietary trade, and what is a trade that is really providing liquidity to a customer and adding value in the after market? I can walk into a trading department, and take a look at the compensation scale, and you can say okay, those are the prop traders and those

are the agency traders. You can just take a look at the pattern of trading, and you can smell it. Basically, people who operate as specialists, with specialists' responsibilities, will be there to participate in the market, normally contrary, against the market, to provide some liquidity to avoid some of the excesses.

The prop traders will almost always go with the trend because they are on a profit-and-loss basis. When they see a raft of selling orders coming in, they want to get ahead of those orders and be short. They don't want to sit there and buy them. So that is your essential problem. And I have no idea how you cure it forever, but you sure can't give them unlimited money. Thank you.

[The prepared statement of Mr. Hambrecht can be found on page 55 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Kelleher?

STATEMENT OF DENNIS M. KELLEHER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BETTER MARKETS, INC.

Mr. KELLEHER. Good morning, Chairman Bachus, Ranking Member Frank, and members of the committee. Thank you for your invitation to Better Markets to testify today. I am the president and CEO of Better Markets. It is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global financial markets. It advocates for transparency, oversight, and accountability with the goal of a stronger, safer financial system that is less prone to crisis and failure, thereby eliminating or minimizing the need for taxpayer-funded bailouts.

I have detailed my background and what Better Markets does in my written testimony. It is also available on our Web site, bettermarkets.com, and I won't repeat that here.

For those who say that high-risk speculative proprietary trading by the handful of too-big-to-fail banks is not a problem, I say look at JPMorgan Chase and the so-called London Whale trade, that so far has cost the bank more than $6 billion and might cost it as much as $9 billion. That doesn't include the more than $20 billion in shareholder market capitalization losses, which are never mentioned. Those billions in losses resulted from a huge speculative proprietary trade using federally-insured depositors' money, which was done to generate profits for JPMorgan.

JPMorgan bet around $100 billion of federally-insured depositors' money, and remember, JPMorgan and its CEO admitted, including right here before this committee, that the risks taken by the traders when they were betting their depositors' money were done without anyone in senior executive, financial, legal, compliance, risk, or others even knowing what the risks of the trade were.

That admission shows that these gigantic banks are not only too-big-to-fail, but they are too-big-to-manage. For those who say that the JPMorgan London Whale prop trade had nothing to do with the financial crisis, I say, one, it doesn't matter because the issue is eliminating or reducing high-risk, speculative trading that could prove lethal to taxpayer-backed banks and require taxpayer bailouts; and two, there are plenty of examples of prop trading in connection with the financial crisis, with Citigroup being the poster child and having to write off almost $40 billion just due to the CDO

positions on its trading book. Because time is short, I won't go into details here, but they are detailed in my written testimony and in the four comment letters Better Markets has filed in connection with the regulators' consideration of the Volcker Rule.

It is important to remember that the Volcker Rule is narrow in application and limited in scope. It prohibits the handful of biggest too-big-to-fail banks from making huge high-risk, speculative bets usually, but not always, with the bank's own or borrowed money. This type of trading is in stark contrast to banks investing and trading their customers' money on their customers' behalf.

Proprietary trading by the biggest banks is nothing more than gambling. Now big-bank gambling like this would be fine if it only threatened the betting bank and if only the bank suffered the consequences of its betting. But that is not the case with high-risk, proprietary trading by the biggest too-big-to-fail banks. Those gigantic banks are backed by taxpayers. Their failure threatens our financial system and the entire economy, and as a result, the banks get the upside of the gambling and taxpayers get the downside, as evidenced by the last crisis. And the downside can be enormous.

Better Markets recently did a study showing that the crisis will cost the United States more than $12.8 trillion, and that is a conservative number. Now, banning proprietary trading isn't the only solution, but it is an important part of a solution, along with capital, liquidity, leverage standards, resolution authority, and much more.

Finally, implementing the Volcker Rule, in our view, is not complex or difficult if you follow two keys: Key number one, focus—Bill just alluded to this focus on compensation to break the link between proprietary trading and banker bonuses. We detailed it in our testimony and in our comment letters. You deconstruct and disaggregate the bonus pool, and you will know right where the proprietary trading is, both before and after. That is easy for them to follow, easy for regulators to follow, and easy to police.

Second, and most importantly, the law has to be backed up with swift, certain, and significant penalties for traders, supervisors, and, yes, finally executives.

If those two keys are followed, implementing the Volcker Rule can be done and it can be done without interfering with the permitted activities of market-making, risk-mitigating hedging, and the other permissible activities without prop trading.

As a result, if you do it that way, the ban on prop trading will not harm customers, credit or job creators; indeed, removing the threat posed by these biggest too-big-to-fail banking giants to our financial system and our economy is likely to unleash a renaissance in our financial industry, as transparency, competition, and fairness create numerous opportunities for current and new market participants.

And in closing, I would just like to say, as a native of Massachusetts, and one who has had the privilege of watching the career of Chairman Frank for, it seems like more than 30 years, but I guess it is just 30 years, that I wanted to thank him for his public service. The people of Massachusetts, and the people of the country, I think owe him a great debt.

And Chairman Bachus, I would like to second everything that has been said about you as a gracious, smart, tremendous contributor to the mission over the years, in any capacity here, and your courtesy has been most appreciated.

Thank you.

[The prepared statement of Mr. Kelleher can be found on page 62 of the appendix.]

Chairman BACHUS. Thank you, Mr. Kelleher.

Mr. Plunkett?

STATEMENT OF JEFFREY PLUNKETT, GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT, NATIXIS GLOBAL ASSET MANAGEMENT, ON BEHALF OF THE ASSOCIATION OF INSTITUTIONAL INVESTORS

Mr. PLUNKETT. Chairman Bachus, Ranking Member Frank, and members of the Financial Services Committee, thank you for inviting me to participate in today's hearing. My name is Jeff Plunkett. I am general counsel and executive vice president of Natixis Global Asset Management. Today, I am testifying on behalf of the Association of Institutional INVESTORS, an association that includes some of the oldest, largest, and most trusted investment managers in the United States. Collectively, the association's members manage pension funds, 401(k) funds, mutual funds, and personal investments on behalf of more than 100 million American workers and retirees.

The association supports the Volcker Rule's core objective of limiting risky behavior at banks. However, the current proposed rule is burdensome and goes beyond congressional intent. This could have far-reaching, negative consequences for investors.

Asset managers and their clients rely on banks to execute trades. The regulators' proposed rule will discourage banks from engaging in these transactions, due to compliance costs and uncertainty regarding what is permitted under the rule. In part, this uncertainty comes from the rule's complex, after-the-fact tests for determining what is proprietary trading, which do not reflect the realities of financial markets.

The regulators are doing their best to implement the statute as written, however, unless changes are made, there will be significant disruptions to the market.

The association also includes bank-owned asset managers. We believe the covered-fund restrictions could be focused in a manner that addresses systemic risk, without creating a competitive disadvantage that would lead to fewer choices for investors and less innovation in the marketplace.

In order to address these concerns, the association has offered the committee specific technical corrections. While our written testimony discusses these suggestions in more detail, today I would like to touch on several of our main concerns.

First, with regard to proprietary trading, we support clarification that regulators should focus on trading activities that do not have any connection to customer facilitation. This change would be consistent with former Federal Reserve Chairman Paul Volcker's statements that proprietary trading should be easy to recognize.

Second, with regard to the market-making exemption, Congress must provide clarification to regulators on the definition of "near term." "Near term" means different things in different markets. For certain liquid markets, the near term may be much longer than in other markets. The market-making exemption should apply to market-making activities in illiquid markets or markets that have only episodic liquidity.

Third, in the covered-fund restrictions, Congress should revise and narrow the definition of "hedge fund" and "private equity fund" to exclude all registered investment companies, and specifically identify the factors that must exist in other pooled vehicles before the regulators may designate them as similar funds.

Foreign funds that are not actively marketed to U.S. investors should be excluded from the definition, as should non-U.S. funds, which are subject to supervisory regulation in their foreign jurisdictions.

Finally, Congress should amend the naming prohibition in the Volcker Rule, to allow hedge funds and private equity funds to continue to identify themselves as manager of the fund so long as the fund does not use the word "bank" or the same name as an insured depository institution in the name of the fund.

This restriction, along with the rule's existing disclaimers and anti-bailout provisions, should ensure that the entities are viewed separately in the marketplace.

Mr. Chairman, a technical corrections bill would provide regulators with a clear statement of congressional intent and would go a long way to mitigate the potential unintended consequences that will harm millions of Americans who are saving for their retirement. The changes that we lay out in our written testimony would ensure that we can continue to serve their needs while still meeting the goals of the Volcker Rule.

We commend the committee for considering taking such actions to address industry concerns, particularly prior to further rulemaking from the financial regulators. Thank you for your time today, and I look forward to answering your questions.

[The prepared statement of Mr. Plunkett can be found on page 81 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Quaadman?

STATEMENT OF THOMAS QUAADMAN, VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. QUAADMAN. Thank you, Chairman Bachus, and first, let me thank you, Chairman Bachus, and Ranking Member Frank, for your leadership and work on this committee and for your service. We have enjoyed working with both of you.

And Mr. Hensarling, and Ms. Waters, as you embark on your leadership on the committee, we look forward to working with you as well.

The Chamber agrees with the intent of the Volcker Rule, and that is to stabilize the financial system as well as to protect against federally-insured deposits. We believe, however, that capital and li-

quidity requirements are a better pro-growth means of achieving that goal.

Congress was right to include a market-making and underwriting exemption to the Volcker Rule. Market making and underwriting are important critical tools for non-financial businesses to raise capital. However, regulators are constructing a system to engage in a trade-by-trade analysis to discern the intent of a trade and to determine if it is compliant with the Volcker Rule. This will raise cost of capital formation for all businesses and, in fact, will shut some businesses out of capital markets altogether.

The Volcker Rule must also be viewed in conjunction with other major financial regulatory initiatives, many of which actually converge on the desk of the corporate treasurer. Derivatives rules directly impact the ability of a corporate treasurer to mitigate risk, and lock in prices, as well as ensure access of raw materials for a corporation. My new market fund initiatives, which are currently being discussed, affect the ability of a corporate treasurer to sell commercial paper as well as to employ effective cash-management techniques. The Volcker Rule impacts the ability of a treasurer to enter capital markets as well as raises costs, while Basel III impacts the ability of a corporate treasurer to obtain bank loans, as well as tap commercial lines of credit.

So, one example that a mid-sized corporate treasurer told me is that when they go out and sell their commercial paper, their entire cost for that sale is 46 basis points. Since they believe that the Volcker Rule will prohibit them from entering the commercial paper market, they then have to tap their commercial lines of credit, which are prime plus 1 percent or about 425 basis points or a tenfold increase in their capital costs.

However, you have to remember that commercial lines of credit on the Basel III have a negative risk weight to them so there is a disincentive for banks to actually provide commercial lines of credit. Therefore, the only alternative that is open to the corporate treasurer is to increase their cash reserves.

Corporate cash reserves in the United States are currently $2 trillion, about 14 percent of GDP, which is a historic high number here in the United States. If, because of the Volcker Rule, we have to morph to a higher European level of cash reserves, that would be $3 trillion, or 21 percent of GDP. That means that corporate treasurers will have to idle $1 trillion in cash that could otherwise be used for more productive economic means.

So, because of those impacts as well as the complexity of the Volcker Rule, we believe that the regulators need to repropose a rule to allow all stakeholders the opportunity to view the final rule, give regulators informed comments, and avoid adverse unforeseen consequences before they occur.

We also believe that the Bachus-Hensarling initiative to propose an extension of the conformance period will also allow regulators the time to get it right. At the request of the committee, we provided a letter in September on Volcker Rule alternatives. We believe there are certain legislative alternatives as well as a means of fixing the rule itself.

First off, as I said before, if the Volcker Rule were to be repealed, the higher capital and liquidity requirements in Dodd-Frank will

actually allow regulators to deal with financial institutions which choose to engage in proprietary trading if they choose to do so.

When President Obama first proposed the Volcker Rule in 2010, the rule was envisioned to be an international rule that all major financial players around the globe would follow. However, other players have decided not to go down that route. We believe the legislation introduced by Congressman Peter King, which would stay the enforcement of the Volcker Rule until there is international coordination compliance with a similar Volcker Rule policy, is an important means of protecting American competitiveness.

Finally, we have also listed a number of different specific fixes that we think are important to the Volcker Rule, if it is to go forward; namely, that if financial institutions, and by financial institutions, I also mean nonfinancial institutions that may own a bank or a financing arm, that if they did not engage in proprietary trading, they should not have to construct a costly, intrusive compliance program; that illiquid issuances in both debt and equity, which Congress also recognizes as a problem in passing the JOBS Act, should be exempt; that there should be a clear exemption for joint ventures to protect American competitiveness abroad. There should be an exemption for State and municipal debt issuances, which are key means of financing for infrastructure projects. And finally, 11 months ago, Governor Trujillo sat in this seat and said that regulators did not understand what normal market-making and underwriting practices are.

We believe that there should be a further study of those market-making and underwriting practices so that regulators understand how non-financial businesses access capital markets and to ensure that those businesses are not adversely impacted. Thank you. And I'm happy to take any questions you may have.

[The prepared statement of Mr. Quaadman can be found on page 125 of the appendix.]

Chairman BACHUS. Thank you, Mr. Quaadman.

Mr. Stevens?

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE INVESTMENT COMPANY INSTITUTE (ICI)

Mr. STEVENS. Thank you, Mr. Chairman.

For ICI, let me add our own salute to you and to former chairman Barney Frank for your leadership of the committee during a period of extraordinary challenges. America's mutual fund investors owe you both a great debt of gratitude.

Mr. Hensarling, Ms. Waters, we look forward to working with you and all the members of the committee in the 113th Congress.

I appear today on behalf of the Investment Company Institute. We're the national association of mutual funds, exchange traded funds, closed-end funds, and other registered investment companies. Our members, as you know, manage almost $14 trillion on behalf of 90 million American investors.

Mr. Chairman, by rights, our membership should have few, if any, concerns about the Volcker Rule. Congress enacted Section 619 of the Dodd-Frank Act to restrict banks from engaging in proprietary trading and from sponsoring or investing in hedge funds

or private equity funds. The Volcker Rule was not directed at the Institute's members, that is, at registered investment companies, and yet, unfortunately, the ways in which the five regulatory agencies propose to implement the Volcker Rule would expand the reach of Section 619 beyond what Congress intended. This raises a number of serious concerns for registered funds, for our members.

Chief among the concerns is the fact that the proposed implementing rule could treat many registered funds as hedge funds, a result that contradicts the plain language of the statute that Congress passed. The statute restricts bank's relationships with hedge funds, private equity funds, and "similar funds," as defined by the regulators. The statute defines hedge funds and private equity funds by reference to the fact that these investment vehicles are not registered under the Investment Company Act of 1940, nor regulated under that Act. Clearly, registered funds, which are organized and operated under that Act's strict requirements, are not remotely similar to the funds Congress intended to cover in the Volcker Rule. Yet the definition of "covered funds" offered by the agencies would sweep in many registered funds under the rule.

The same definition would also sweep in all non-U.S. retail funds. Even though these non-U.S. retail funds are comprehensively regulated in their home jurisdictions, just as mutual funds here are in the United States. And, therefore, are not the type of funds that Congress meant to reach. In addition, some U.S.-registered funds and non-U.S. retail funds could be traded under certain circumstances as banking entities, which would anomalously subject them to all the prohibitions and restrictions of the Volcker Rule itself.

Implementing the Volcker Rule in this way will impede the organization, sponsorship, and very normal activities of U.S.-registered funds and of non-U.S. retail funds alike. And investors will suffer as a result. Now, in detailed written submissions and numerous meetings, ICI and its international affiliate, ICI Global, have urged the agencies to provide explicit exclusions from the Volcker Rule for U.S.-registered funds and non-U.S. retail funds, as well as clarification that these funds are not "banking entities."

Registered funds also must look at the Volcker Rule and its implementation from our perspective as investors in the capital markets. We do not believe that the proprietary trading restrictions as currently proposed will achieve their apparently narrow intended goal of addressing risky and speculative trading by banks. Instead, they are likely to have broader adverse impacts on the financial markets in the United States and abroad, and in the process, will penalize registered funds and other investors who participate in these markets.

The proposed trading restrictions could decrease liquidity, especially for those markets that rely most on banking entities to act as market makers, such as the fixed-income and derivative markets and the less liquid portions of the equities markets. A reduction of liquidity could ultimately lead to higher costs for funded shareholders and for other investors. Similarly, the proprietary trading restrictions call into question whether banking entities could, for example, continue to serve as authorized participants and market makers for exchange traded funds.

Banks play a critical role in ETF trading to help maintain efficient pricing and to protect ETF investors. We recommend that the rule be clarified to spell out that banking entities can continue to support the efficient functioning of the ETF market.

Now, in this and many other areas of our concern, we believe the agencies implementing the Volcker Rule have it within their power to avoid all of these harmful consequences for funds and their investors. Given the number and seriousness of the issues that need to be addressed, however, we have recommended and we continue to urge that the agencies issue a revised proposal for public comment before adopting any final rules.

Further, we are deeply concerned about recent press reports that raise the possibility that agencies will adopt final Volcker Rule regulations that substantially differ one from another. This would be a true disaster. And it would fly in the face of Congress' express direction that the agencies coordinate their rulemakings. We urge that the committee do all that it can to ensure the consistency of any final rules issued by the agencies.

Finally, if the serious adverse consequences for registered funds are not addressed through the regulatory process, ICI has suggested potential legislative changes to address several of our concerns. We stand ready to work with the committee and interested Members in this regard.

Mr. Chairman, thank you for the opportunity to present our views. I would welcome any of your questions.

[The prepared statement of Mr. Stevens can be found on page 137 of the appendix.]

Chairman BACHUS. Thank you. At this time, we will have questioning by the Members.

I would like to recognize Mr. Brad Miller, who is retiring. Mr. Miller really was a leader in this Congress in highlighting subprime lending practices in the early 2000s. And I commend him for that. Some of his predictions unfortunately came true.

At this time—would you like a minute?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. I have appreciated the chance to serve on this committee for a decade and I have appreciated the relationships, valued the relationships that I have had with other Members, with our staff, and with the folks who sit back there, some of you, anyway. The folks who sit over there, as well.

Mr. Chairman, I would like to join in the kind of general spirit of this meeting and say nice things about you. But the last time I did that, it didn't work out well. Three or 4 years ago, someone who sits over there stopped me in the hallway and said they were writing an article about you and asked me to comment. And I said nice things. And then a day or two later, the article came out. And the lead was that some Republicans did not trust Spencer Bachus because he got along too well with Democrats. And the second paragraph quoted me, saying how well I got along with you.

And, Mr. Chairman, in the next several meetings after that, you seemed to go out of your way to pick a fight with me about something or another, showing that we really didn't get along. And I wanted you to know that since that time, whenever anybody has

asked me publicly what I think of you, I have said, "I don't like that son of a bitch."

And, Mr. Chairman, I want you to know that I have done that as a personal favor to you.

Chairman BACHUS. Thank you. And, Mr. Miller, it helped me in my primary.

At this time, I would like to recognize Mr. Quico Canseco for 2 minutes for questions.

Mr. CANSECO. I, too, want to thank you, Mr. Chairman, for your leadership on this committee. It has been a privilege serving on the Financial Services Committee, albeit for a short 2 years. It has been quite an honor to serve on this committee and regrettably, I won't be here in the next Congress.

And thank you for the opportunity to ask some questions here.

Professor Barth, is there even a practical way to distinguish between proprietary trading and market making?

Mr. BARTH. In answer, I would say that it is going to be extremely difficult. And my concern is that the attempt to do so may actually eliminate beneficial trading activities by banking entities.

The other part of my answer would be that to the extent that banks are concerned about whether or not they are indeed engaging in proprietary trading, it may deter them from beneficial trading activities. I think it is extremely difficult to judge the intent of banking entities when it comes to proprietary trading. As we all know, there is the time factor over which one is going to try to determine whether or not a bank is engaged in proprietary trading or speculative trading activities and other legitimate and permissible trading activities. That is my biggest concern.

Mr. CANSECO. So even if regulators were to somehow make this distinction, which is unlikely, as you say, in your opinion, would a final regulation make the financial system any safer?

Mr. BARTH. No. I don't think there is any evidence whatsoever, despite what some people claim, that proprietary trading has or will cause those sort of problems. As pointed out in my testimony, it turns out it was basically poor underwriting and lending practices relating to the real estate sector that really triggered the crisis and is the major concern.

And one should not talk about losses per se. Whether or not JPMorgan Chase incurred a loss of $6 billion or $9 billion is not the issue. The issue is really whether or not there is sufficient owner-contributed equity capital on the part of that bank to cover that loss. One can talk, as I did in my testimony, about losses, but it is losses relative to equity capital which is the issue, not just big numbers to throw out and say there are big losses. Is there sufficient equity at financial institutions to cover those losses? And that indeed has been the case, as I point out, I think, in a little more detail in my testimony.

Chairman BACHUS. Thank you.

At this time, the gentlelady from New York, Ms. Hayworth, is recognized for 2 minutes.

Dr. HAYWORTH. Thank you, Mr. Chairman. And I echo the lavish and well-deserved praise that you have received this morning. And I know that you are going to continue to illuminate our proceedings as you retire to emeritus status.

And with that, Professor Barth, I couldn't agree with you more about the root causes of the crisis that precipitated the passage of Dodd-Frank and this attempt to create barriers that are obviously very, very difficult to define.

Mr. Hambrecht, I was reading your testimony. And you refer, of course, to one of the primary problems being unlimited leverage, essentially taxpayer-backed, low-cost financing.

So we are looking at—and you speak of exerting market discipline. Eventually, market discipline did come to bear in a fairly catastrophic way, as we know, in 2008, because you can't repeal the laws of gravity, so to speak, you can't repeal the laws of economic physics.

What would the most elegant solution to this problem be, given what you have said, Professor Barth, and what you have said, Mr. Hambrecht? Should we be exerting energy, because there is a cost of capital here, there is a cost of effort, should we be exerting all this energy on trying to create these barriers or should we go back to the root cause and devote our energies to withdrawing the Federal Government from activities that create market risks to begin with in unnatural ways?

Mr. HAMBRECHT. There are a lot of solutions, I am sure, that might work. I still think that the key to it will be the recognition of what functionality those trades are in. And I maintain you can have a reasonable basis of judgment as to what is a proprietary trading account and what is a market making.

To me, the best solution would be to go back to the original margin requirements and approach that Glass-Steagall took. And, basically, what they said is margin is allowed on exchange-based trading, where you have specialists who have obligations to make an orderly market. And you have the right to say how much you can borrow against that piece of paper.

So to me, the Glass-Steagall pattern of transparent, open markets and margin requirements that are basically enforced on a real-time basis, so that you are sold out before you can get your other parts of your balance sheet in trouble, I think that would be the most elegant solution.

Chairman BACHUS. Thank you.

Dr. HAYWORTH. Thank you, Mr. Chairman.

Chairman BACHUS. Mr. Schweikert for 2 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

First, Mr. Chairman, thank you for your kindness. And also to Scott Garrett as my subcommittee chairman. Thank you for tolerating me. My greatest joy I have had in my 2 years here in Congress is this committee, and I am going to miss it.

Quick question, and I will try not to repeat other ones who have come through.

Mr. Quaadman, you sort of touched on this. I have a great concerned interest in liquidity of fixed-income markets, particularly municipal, quasi-municipal debt. A lot of the bigger institutions often as good community players will be the ones that step in, either when we have done a defeasance or other things, and player. Will that type of concentration start to play in the margins of the Volcker Rule?

Mr. QUAADMAN. In the legislation, there are certain disincentives, actually, for State and municipal debt. So it will be more difficult for State and municipalities to go into capital markets and raise bonds in certain instances because they are going to be subject to the Volcker Rule. So that will entail larger costs and, in fact, may actually shut them out of certain markets.

The Conference of Mayors actually passed a resolution on this several months ago highlighting those concerns and asking that this be fixed.

So we believe that this is something that Congress should go back to in order to address. And this particularly impacts education projects, and transportation projects. The University of Massachusetts system would be affected by $150 million—

Mr. SCHWEIKERT. Thank you, Mr. Quaadman.

This one, Mr. Chairman, both right and left, this may be one of those areas where we can all agree that we may have to do a fix because it affects a lot of our communities, our sewer districts, our States, and our communities, and I think it is something we could fix in a bipartisan manner.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you.

At this time, Ms. Waters recognized for 6 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

Since this is a moment where we have an opportunity to share our thoughts and our feelings about you and Mr. Frank, I just want to tell you that I have appreciated so much working with you. And even though we have worked together on this committee, our work outside of this committee where we worked on debt relief was extremely important. We were successful in helping to alleviate some of the pain and poverty in some of those countries that we spent time on. And I want to thank you so very much for that. And I won't say very much more because I don't want anybody to get the idea that we are really friends. You have been in enough trouble without that.

Barney Frank, let me just say that having worked with you has been an extraordinary experience and having served on the Dodd-Frank Conference Committee was a highlight of your work and my work on this committee.

Most everyone here has said how much we are going to miss you and that is really an understatement, because this institution has been able to solve some great problems with your leadership, and we have all learned so very much from you. And we expect that you will be by the telephone and we may call you, even in the middle of a committee hearing, a markup, when we need to. And you don't have to answer that now because you may tell me where to go. Thank you very much.

Okay. Let us get to Volcker.

Mr. Kelleher, you gave such passionate and strong testimony just a few minutes ago about Volcker. And I am very appreciative of that. And, I have been leaning in that direction. But I have also heard today some criticisms that seem to be based in some facts or documentation. And I would like you to take time to address some of what I heard, particularly from Mr. Stevens—from all of the members who have testified in opposition to your thoughts.

Would you please share that with us?

Mr. KELLEHER. Thank you. I think one of the things that is most surprising is the collective amnesia that has run rampant on Wall Street since the Volcker Rule came in. There was a time—and Chairman Frank can appreciate how amnesia comes and goes, it is not just in this building.

But, if you go back to 2007 or 2006, there didn't seem to be a massive problem with distinguishing between proprietary trading and market making or risk-mitigating hedging. People knew what it was. After all, these were supposed to be the smartest people in the world making the most money in the world; the best of the best, the brightest of the brightest. And since the Volcker Rule, there has been this massive problem: What is proprietary trading? What is it not?

And, frankly, it is more of a problem in Washington. I talk to traders and bankers all the time. I had a breakfast the other morning with a very senior executive banker. These people laugh at the concept that they can't tell the difference between proprietary trading and market making or hedging.

Frankly, if they couldn't, that means they couldn't segregate customer funds. It means they couldn't comply with many laws, rules, and regulations on compliance and risk and capital. Do you think it is true that the executives at any one of these big banks has no idea at their trading desk that the trader or the desk doesn't have capital, risk, and compliance requirements? No. They all have their risk limits, their capital limits—they can't be putting the bank's money at risk and putting the bank itself at risk without everybody knowing exactly what it is moment by moment. And as it gets rolled up, they also know it on the aggregate level, not just at the desk level, but at the division level and department level by P&L and otherwise.

So I think many of the complaints that we hear are really attacking financial reform and attacking—

Ms. WATERS. What do you say about the competition argument that is being presented here?

Mr. KELLEHER. I think there is something to be said in terms of a transition period of any new rules and how they disparately affect market players across countries. But that means that we need integrated harmonization, not that we need to lower the bar. There should be a race to the top, not a race to the bottom. The cross border rules are going to be very important in that.

But as was alluded to earlier, every country is trying to struggle with trying to limit this high-risk speculative trading by the banks. In the U.S., it is Volcker; in the U.K., it is Vickers; in the E.U., it is the Liikanen report.

So I think the problem with competitive concerns are more of a transition period than an ultimate issue. And the sooner we get to final rules and harmonization, the better off we all are.

Ms. WATERS. It was attested in the King legislation that was brought up that we should delay implementation of the Volcker Rule until there is harmonization. What do you say about that?

Mr. KELLEHER. I would say that the schizophrenia of the complaints are just astonishing—I almost get whiplash. Originally, it was like, "Our problem is lack of certainty. We need certainty. We

need clarity." And now that they are going to get certainty and clarity, "We don't like that, so we need you to delay it so we can have a longer period of uncertainty and lack of clarity."

Let's gets certainty, clarity. Let the regulators do their job. They are really on the cusp of putting in a very substantial architecture in the derivative space and in the Volcker Rule and other areas. Let them get the job done. Let's see how it works. It works together or it doesn't. And then, let's revisit it with the actual knowledge, other than self-serving statements by market participants that are really no more than guessing.

But let's protect the American people. It has been 4 years and 3 months almost to the day since the Lehman failure. Our job is to protect the American people from another financial collapse and a potential second Great Depression brought on by a financial collapse. Let's get the rules in place, get the clarity. And where it needs to be fixed, let's wait to see how it works or doesn't work and fix it then.

Ms. WATERS. Just lastly, I have been told that Chairman Shapiro has entered into some negotiations, some talks with the other regulators, and that she is bringing something to the table that is going to help wrap this all up very soon. Do you know anything about that?

Mr. KELLEHER. I only know what I read. And, of course, if I read it, it must be true. Because it was in the papers. Right?

But I do think that if they focus clearly on compensation—if you eliminate the compensation incentive for prop trading, which can be easily policed and easily followed both in the banks and by regulators, and then you back it up with swift and clear sanctions, they can get the Volcker Rule in place quickly with very little market disruption and very little regulator intrusion into the business of the banks.

Chairman BACHUS. Thank you.

Ms. WATERS. Thank you very much.

Chairman BACHUS. Of course, what Ms. Waters is referring to is the article in yesterday's Wall Street Journal and about those conversations.

Mr. Hensarling for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Kind of a stock and trade often in these committee hearings is to try to separate purported benefits of rules from their actual benefits and certainly weigh them against their actual cost, and to essentially determine whether the cure may not prove to be worse than the illness.

I think we have all taken note of Chairman Volcker's statements that, number one, proprietary trading in commercial banks was not central to the crisis. And then he has expressed concern with the rule bearing his name, "I don't like it but there it is. I would write a much simpler bill." I don't think quite think he has put his offspring up for adoption, but he doesn't seem to be too pleased with it.

Mr. Kelleher, in your written testimony you state the Volcker Rule "is narrow in application and limited in scope." You further testify, "it only applies to a few banks."

And yet as the vice chairman of this committee, I have noted not a few, not hundreds, but literally thousands of negative comments that have either arrived to this committee or to the regulators from entities that supposedly are not negatively impacted.

One of them being TIAA-CREF, which I believe to be one of the largest pension funds in the Nation, taking care of numerous teachers. And they wrote a letter to regulators, "Depriving the insurance companies that invest on behalf of those pensioners, the returns available through investments in covered fund impairs the ability of those pensioners to maintain their retirement security."

I have a cousin who spent her entire life teaching in a small town in central Texas, who is now retired. I note that the Federal Reserve hasn't done her and other pensioners any favor as of recent, including their actions yesterday.

So when I think about her and her husband also, somebody who spent their entire life in teaching, getting by on pretty much of a fixed income, I am wondering at the end of the day, I hear much language here about the big banks. But to what extent are we thinking about the little teachers?

I also think about one other comment we received from the Public Utility Commission of Texas, in my home State, "The Texas PUC is concerned that the wholesale and retail power markets within the electricity, electric, or reliability council of Texas are likely to be materially and adversely affected from the approach taken by the agencies. The limitation will result in higher and more volatile electric prices to end-user customers."

These are two comments that literally are representative of thousands of comments that we have received.

And so with the onset of winter—I know that perhaps Massachusetts might be colder than Texas—but I think about a lot of low-income people in the Fifth Congressional District of Texas, who struggle in this economy to pay these utility bills. And now, I am hearing from not a big Wall Street bank, but a government entity in my home State, saying that the current iteration of the Volcker Rule is going to make winter more challenging for them.

Mr. Kelleher, how have thousands got it wrong and you got it right? I will give you a moment to explain.

Mr. KELLEHER. I think there are a couple of things. First of all, we obviously are not looking forward to or advocating policies that we think are going to disrupt the markets. Well-functioning, deep, liquid markets are the basis of our economy; we need them to work; and we need them to work for everybody from the teacher in Texas to the banker on Wall Street, to everybody else on Main Street. So what we need to do is design a system that serves all those interests and not primarily a narrow sector of that.

There is no cost that—this is a slight overstatement—I can think of associated with the Dodd-Frank Act that comes anywhere close to the cost imposed on the American people and the economic wreckage from the last financial crisis or the next one.

And that is what we have to be focused on. That is the cost that is already inflicted—

Mr. HENSARLING. I see my time—

Mr. KELLEHER. Second, most of those complaints ignore entry by new market participants.

Mr. HENSARLING. My time has expired. I yield back.

Chairman BACHUS. Mr. Baca?

Mr. BACA. Thank you, Mr. Chairman. First, I would like to thank you. It was an honor serving here in the Financial Services Committee. I would like to also thank Chairman Frank—Barney, too, as well. I thank you very much. And of course, I look forward to continuing to stay active in some of these issues that are important to a lot of us. And it has been an honor not only for me to have served here, but those who are currently serving right now. Because these issues that are impacting us in Financial Services impact the market and where we are going to be in terms of the future, not to mention housing and other areas, as well.

But let me ask this question of the panel, and anyone on the panel can answer: Are there any particular transactions or positions to which applications of proposed definitions of trading account that is unclear?

Mr. STEVENS. Congressman, if I might, one specific point that is covered in my testimony has to do with the ambiguity of the application for proprietary trading restrictions to the activities that banking entities engage in as authorized participants and market makers to support exchange-traded funds. Those are an extraordinarily popular and growing part of the registered fund industry in the United States. And it is not clear under the rules whether that would or would not be regarded as proprietary trading.

I will say that in response to Mr. Kelleher's comment—

Mr. BACA. Does it need to be made clear?

Mr. STEVENS. Yes, it does. And we have urged that it be made clear.

You must understand, the way that the rule as proposed works, there is a presumption that any trading activity that the bank engages in is proprietary trading, unless it is proved otherwise.

In other words, you are guilty unless proven innocent. And getting that wrong has very serious compliance implications.

Mr. Kelleher's colorful comments are not grounded in actually the rule proposal. Our comments are not amnesiac. Ours are grounded in exactly what the agencies have put forward. And unless it is clarified, it will, for example, potentially impact this market, in which millions of ordinary Americans participate.

Mr. BACA. So the innocent are guilty before proven.

Mr. STEVENS. The rule, as written, as proposed, presumes that everything a bank engages in is proprietary trading.

Mr. BACA. Thank you. And this is another question for the whole panel. Do you think the proposed rule approach to implementing the hedging exemption is effective? If not, what alternative approach do you think would be more effective?

Mr. HAMBRECHT. Let me try. First of all, I want to second Mr. Kelleher's statement that people know what is a prop trade and what is an agency trade. Historically, it used to be divided by whether you acted as principal or whether you acted as agent. If you acted as agent, clearly, that was not a prop trade. You had no economic interest in the trade.

The minute you become a principal trader, you have an economic interest in the success of the trade; you don't get a commission, it is based on the success of the trade.

So I think anybody can define that very clearly.

I think the problems become much more complex when you go into derivative markets or you go into other markets where the definition of the risk is hard to understand. And the definition of the impact on counterparties is hard to understand.

And I think the only way you can really do that is to have transparent trades and have much more standardization of derivative trading, hopefully, on exchanges.

Mr. BARTH. May I add that the issue is not whether or not bankers can distinguish between proprietary trade and through principal trading activities, can regulators make that distinction and determine the intent of the bankers. I think that is an important point that hasn't been made. So we are not talking about bankers trying to distinguish between proprietary trading and permissible trading activities. Regulators, and does anyone have sufficient confidence that regulators would make the right distinction?

Mr. KELLEHER. It is not so much intent. It is economic interest, which is tracked to the penny at these banks. So your intent is almost irrelevant. People say you need a lawyer and a psychologist on your shoulders. It is not true. Look and see how the trader is running his book and look at the book on the desk. They track to the penny whether or not it is the bank's money or a customer's money. And whether—which side they are on, and how it changes minute to minute. Once they take a position, they monitor it very closely. That is because their money is at risk. They know it. So it is not an issue of intent. It is an issue of clearly identifiable contemporaneous economic interest.

Mr. BACA. And if it isn't done, then it could impact the consumer. I think that is the question that was asked earlier in terms of some of the residents in the area. Is that correct?

Dr. HAYWORTH [presiding]. The gentleman's time has expired. I would like to ask unanimous consent to enter into the record statements from the American Council of Life Insurers; the Bond Dealers of America; BBVA Compass; and the Institute of International Bankers.

Without objection, it is so ordered.

And now, 5 minutes to the gentleman from New Mexico, Mr. Pearce.

Mr. PEARCE. Thank you, Madam Chairwoman.

I would like to associate myself with the comments that Mr. Schweikert made about the need for financing for local projects and small States since that is a very key thing and I think this question pertains to that.

Mr. Kelleher, I was interested in your comments that the regulator's job is to protect the American people. And if you have watched any of my recent questioning in the area, you find I have a fascination with MF Global.

Do you have an opinion about the regulators and their protection of the American people in the application of that—those final hours of MF Global?

Mr. KELLEHER. I only know what is in the public record. And so far, I think the answer has to be that the public record isn't really complete enough yet to have an opinion.

Mr. PEARCE. Let me complete a little bit of it for you.

As they were sitting there, both the CFTC and the FTC sitting in the room, were counting down the last hours before this billion, billions of dollars corporation fails. They have been taking the funds from segregated accounts to float the deal.

The regulators decided at the urging of the FTC, at 5:20 in the morning, to declare it a securities firm, not a futures trading firm, not a commodities market—30,000 commodity accounts and 318 security accounts. I think the two guys who were responsible for the decision—this is my thoughts, they have never exactly confirmed it. They didn't confirm it yesterday when they were hearing, but they were in the room making the recommendations—that their recommendations, it was declared a securities firm, not a futures, not a commodities firm—318 to 30,000, and they decided for the 318. The bankruptcy proceedings then favored the investors, not the 30,000.

So I guess my question is, when you assure us all that the Volcker Rule is going to be good, it is going to protect the American people, we had the guys here yesterday who made those decisions to not protect the American people but to protect the 1 percent.

Now, if my assertions are correct, and neither one of the gentlemen yesterday who apparently were in the room or on the telephone with the people in the room would contend with it, do you have an opinion now about the regulators doing their jobs?

Mr. KELLEHER. I don't think there is any question that regulators, like legislators and everybody else, are not perfect and are going to make mistakes. And one of the reasons we advocate clear rules, particularly on Volcker, focusing on compensation, is because discretion and judgment are largely taken out of it. And it would be a rule that would both be easy to comply with and easy to police. We try and find, take the ambiguity out of the rules—

Mr. PEARCE. Reclaiming my time, I really did want an answer, because you are very articulate and you are very opinionated. You are willing to use the words "amnesia" and "schizophrenic" in regard to businesses, but you are unwilling to describe activities on the part of regulators as maybe preferential—

Mr. KELLEHER. Don't get me wrong; I am perfectly happy to join in criticism of regulators.

Ms. PEARCE. I am trying to give you a chance to respond. And I didn't find that clarity in the response. So if you don't mind, it would make my observations—

As you describe the perfect world of regulators, I worry that the protection of our consumers is not going to be any closer under the Volcker Rule than it is under the SEC, the CFTC, the REMC, the ABC, nothing.

I think that people are always going to find their way out. Just looking yesterday at the HSBC, we sent Martha Stewart to jail for 4,000 shares of stock, whatever happened there, 4,000 shares. But billions of dollars over multiple years for the HSBC laundering money in our judicial department didn't seem to find a reason.

So I don't think—I know there are mistakes made by businesses. But I am not sure in your perfect world of regulations and regulators to where we regulate the very last common denominator will end up choking off investments to small towns in New Mexico. I

am just not sure your process is going to get us any closer than what we are doing now.

Thank you. I yield back.

Dr. HAYWORTH. Thank you, Mr. Pearce.

The Chair now recognizes Mr. Miller of North Carolina for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Madam Chairwoman.

Before I begin, I would like to ask unanimous consent to introduce into the record a report from Public Citizen which finds that 99.9 percent of banks would not be affected by the Volcker Rule.

Mr. Kelleher—

Mr. FRANK. Madam Chairwoman, is that going to be in the record? We need to have an order.

Dr. HAYWORTH. Without objection, it is so ordered.

Mr. MILLER OF NORTH CAROLINA. Thank you.

Mr. Kelleher, the Volcker Rule is one of the provisions in Dodd-Frank designed to make banks simpler, less likely to fail, and if they do fail, to fail without such catastrophic consequences to the financial system and for the broader economy.

But just in the last couple of weeks, William Dudley has spoken on the first versions of living wills and said we have a long way to go before we have a financial system that will not—that a major bank can fail, the kind of banks that would be subject to the Volcker Rule could fail without catastrophic consequences to the financial system. And even more strikingly—and that it was the beginning of an iterative process, that we would get there eventually.

Even more strikingly, HSBC, just in the last couple of days, has entered into a settlement for $1.9 billion in fines for money—for laundering $800 million in drug money, in addition to having laundered money for the Iranian regime and the repugnant genocidal regime in Sudan. And the stated reason what they said right out loud in front of God and everybody was that they weren't going to bring criminal charges because of the disruptive effect it would have on the global financial system.

I think Chairman Frank was correct when he said earlier that Dodd-Frank has made many of the extraordinary interventions of 4 years ago no longer within the law. But is it—do you think that the biggest banks can fail without significant consequences for the financial system or the broader economy?

Mr. KELLEHER. Not yet. We still have a long way to go under Dodd-Frank. We need not just living wills and resolution authority. At the front end, the Fed has to get in place a whole variety of liquidity, capital, leverage requirements. That has to be married up to the back end on resolution authority, which is the FDIC's Orderly Liquidation Authority. They have gone very far on that. They have just announced recently an international agreement with the U.K. on resolution. And the president of the Bank of England was just here discussing that with the head of the FDIC publicly.

But you take all of these things and you put them in place, if they get put in place in good faith by people intending to achieve the objective of ending too-big-to-fail, including, importantly, banning proprietary trading and limiting the investments in hedge

funds, et cetera, you could be at a place, at a point in time, where you do eliminate too-big-to-fail.

Mr. MILLER OF NORTH CAROLINA. I am puzzled by the hand-wringing, though, at the idea that intent could be a factor in the law. Oliver Wendell Holmes said intent is the concept that runs throughout the law, that a dog knows whether he has been kicked or stumbled over. It is something we deduce from circumstances all the time in our ordinary lives. And it is a common legal concept that we frequently have to have deduce for consequences.

Can you think of other areas in the law in which important consequences may depend upon determinations of intent?

Mr. KELLEHER. Every single criminal prosecution. Every single civil litigation, contracts. It is a fairly routine concept, intent. But the important thing about this—I think it is a phony argument, that you have to discern the intent of a trader to find out whether it is a prop trade or not. That is not factually accurate. Don't take my word for it. Talk to real traders. Talk to people who run desks about how it really works. There is documentation. So intent isn't involved there.

But, where intent is interestingly involved is if you are going to hold somebody accountable under the law. And we haven't seen that happen in connection with the financial crisis at the largest banks. There are no executives who have been held accountable in any serious way. Basically, the banks have used shareholder money to pay big fines to move on.

So it would be nice, actually, if people who were worried about intent would think about determining the intent of people who engaged in some pretty egregious conduct before the financial crisis, took billions of dollars in bonuses, and stuck the American people with the bill. They might want to look at the intent of those actions.

Mr. MILLER OF NORTH CAROLINA. The proposed rules or some of the discussion, does it—do they outline circumstances that might suggest what the intent was, whether it is proprietary trading or market making or hedging? And what are some of the circumstances that might indicate what the intent was?

Mr. KELLEHER. You are going to know, because if you look at the trader's book, the trader has an allocation as to risk—

Dr. HAYWORTH. The gentleman's time has expired.

Mr. Luetkemeyer is recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

Mr. Stevens, I will start with you.

You handled a mutual fund investment company and are the director for the Investment Company Institute. And I know that you talked in your testimony with regards to mutual funds and they need to be out of the Volcker Rule umbrella.

Can you elaborate on it a little bit? Can you differentiate between mutual funds and hedge funds and why you think—how they don't interplay and shouldn't be considered here, and the effects of the rule?

Mr. STEVENS. Tough question, Congressman.

This is really a very bright line, and I think everyone understands it quite well. And Congress drew it in the Volcker Rule.

Mutual funds and other registered investment companies under the Investment Company Act of 1940 are subject to all of the major Federal securities laws. In fact, there is no more heavily-regulated financial product in the market today. Mutual funds are required, for example, to—under the statute, to avoid the full range of potential conflicts of interests with their sponsors. They are subject to a very specific governance regime. They are subject to an enormous amount of transparency in terms of their disclosure to investors. They are subject restrictions in the way that their portfolios work and the kinds of investment strategies that they can pursue.

Hedge funds, on the other hand, are subject to none of that. They are private investment companies. Their advisors, after Dodd-Frank, have to be registered with the SEC. But the hedge fund can pursue whatever strategies it wishes, provided only that it is either sold to a sophisticated group of investors—and I put quotes around "sophisticated," because that is another issue that needs to be addressed at some point—or to a very limited number of investors.

Now, the key thing in addition is that other markets outside of the United States are subject to similar sorts of dichotomies in terms of the funds that are made available in the market.

So that there are, for many purposes, funds that look very much like U.S.-registered funds, U.S. mutual funds that are sold outside of the United States and in very many instances are sponsored by American fund advisors.

Our point is that both of those kinds of funds, both the U.S. funds and the non-U.S. funds that look like American mutual funds, should be outside of the covered funds provisions and the banking entity provisions of the Volcker Act. And we hope the regulatory agencies will clarify that.

Mr. LUETKEMEYER. Mr. Plunkett, do you agree with that? You handled investments of a similar nature.

Mr. PLUNKETT. Yes, Congressman.

Foreign funds, many foreign funds such as UCITS funds in Europe and certain funds, OEICs in the U.K., are already heavily regulated and very similar to U.S. mutual funds.

The regulators need to make a distinction between what types of funds are really sought to be covered by the Volcker Rule and what should be excluded—the exclusion should include all U.S. mutual funds.

Mr. LUETKEMEYER. Mr. Quaadman, we have hardly talked at all today, yet with regard to getting an extension for all of the entities which are going to have to comply with the Volcker Rule because at this point, not all the rules are out there. Not all the rules—the final rule hasn't been set, and interpretation of it, there is a sort of a nebulous framework out there.

But you have 2 years to comply from July 21st, and the clock is ticking. And yet there is nothing there for you to comply with, technically. At least from my understanding of it.

So my question to you is: Are all of you working in coordination to try and get an extension of the Federal Reserve compliance period here so—until the rules are promulgated and finalized, that you actually know what you are going to be doing so you can have the proper amount of time to comply?

Mr. QUAADMAN. I think that is a great question. That is why I mentioned in my opening statement why we think the Bachus-Hensarling request for an extension time is important.

One thing I want to say as well, because I think this has been bandied about a bit, but I think it is also is emblematic of the problems with the Volcker Rule itself. One of the examples that has been used here has been the London Whale example. Right? And with the financial institution where that occurred, there are dozens of regulators who are embedded in that institution go there every day, are supposed to be looking at the activities of that bank. To this day, they can't tell you if that was a proprietary trade or not. So if they cannot tell you if that was a proprietary trade or not, for a corporate treasurer who has to go to the capital markets every day who is going to have to go through intense regulatory scrutiny as to when they go out and sell their bonds or their stocks, how are they going to have any certainty for how the market is going to react or the regulator is going to react?

Mr. LUETKEMEYER. I appreciate your comments. My time is up. Thank you. I yield back.

Dr. HAYWORTH. Mr. Lynch of Massachusetts is recognized for 5 minutes.

Mr. LYNCH. Thank you, Madam Chairwoman.

Let me ask you on that point, Mr. Kelleher, is there a legitimate claim here that some folks couldn't distinguish between proprietary and nonproprietary?

Mr. KELLEHER. My answer would be, it is clearly proprietary. And JPMorgan Chase CEO Jamie Dimon, who testified both in the House and the Senate, agreed when he said, "I can't tell you if it is or it is not."

I guarantee you if it was not, he would have said that.

Mr. LYNCH. Right.

Mr. KELLEHER. I don't think there is really any doubt of anybody who is independent, looking at what happened there and what the trade was, based on what we now know—there is still a lot we don't know—but based on what we know, it was pretty clearly a proprietary trade.

Mr. LYNCH. Mr. Kelleher, what I really want to do is follow up on my friend's line of questioning, Mr. Miller from North Carolina, regarding the HSBC case that was announced yesterday.

We really aren't talking about just too-big-to-fail in this case. Now, just to sort of regurgitate the facts here, HSBC yesterday entered into a deferred prosecution agreement with the Justice Department after they had admitted that they violated the Bank Secrecy Act and the International Emergency Economic Powers Act and the Trading With the Enemy Act. They actually conducted illegal transactions with Cuba, Iran, Libya, Sudan, and Burma, all countries that were subject to the sanctions enforced by the Office of Foreign Asset Control at the time of the transaction.

And there is no question that they knew what they were doing. They actually scrubbed some of the reports so that it wouldn't flag what they were doing.

But what troubles me greatly is they agreed to a $1.92 million penalty, but the Justice Department agreed not to prosecute be-

cause they were afraid of what the financial reverberations would be to the market.

So these folks aren't just too-big-to-fail, they are "too-big-to-indict," to steal a phrase from The New York Times editorial yesterday.

And it would seem to me that the Volcker Rule would be very helpful in stopping these banks from getting so enormous that any—that they become immune from prosecution, which defeats the entire purpose here.

How do we get at that? How do we get at that situation where these banks are clearly violating, knowingly violating the law? And doing so at risk to the entire markets? How do we not prosecute these guys and just put a little slap on them and allow them to continue to do what they have been doing?

Mr. KELLEHER. Everybody knows that unpunished crime does not deter crime. In fact, unpunished crime incentivizes and rewards crime and ends up with more crime. So it may be the case that HSBC or other banks are "too-big-to-indict," because you don't want to have them collapse. And there is the consummate example of the Arthur Andersen accounting firm.

But that doesn't mean that individuals can't and shouldn't be prosecuted and put in jail. A bank may be "too-big-to-indict," but there is no banker who is "too-big-to-indict." And without accountability, be it for egregious conduct engaged in a run-up to the financial crisis, or be it HSBC or otherwise, the failure to hold senior executives accountable and other executives, officers, and employees who knowingly break the law, if you don't do that, you greenlight them to do it more.

And you are exactly right in terms of proprietary trading. The problem with proprietary trading is the riches and the rewards are so massive, the temptation is so huge because the rewards are so high, that it has to be limited. And it is one of the key ways to cut down on high-risk activity at taxpayer-backed banks that risk failure and taxpayer bailout. But both of those go together. Some accountability and prosecution of individuals, whether they are a banker or not, should not be limited because you are concerned about the institution itself.

Mr. LYNCH. I haven't read the entire deferred prosecution agreement. But the only thing that I can see through in these documents is that there was a partial claw-back of some of the bonuses that were given to some of the officers of the bank. That was it. Now, I understand that the Brits are also going to move forward with their own prosecution. So maybe, maybe because it is a London-based institution, maybe it will come during that prosecution.

But I still think—I agree with your statement that there should have been much more severe consequences for these folks. Actually, money laundering for Cuba, Iran, Libya, Sudan, and Burma, in the face of the sanctions that Congress has placed—

Dr. HAYWORTH. And the gentleman's time has expired.

Mr. LYNCH. Thank you, Madam Chairwoman.

Dr. HAYWORTH. Thank you, sir.

Mr. Stivers is recognized by the Chair for 5 minutes.

Mr. STIVERS. Thank you, Madam Chairwoman.

My first question is for Mr. Quaddman. Why do you think it is important to look at the Volcker Rule in conjunction with other regulatory structures such as the Basel III?

Mr. QUAADMAN. Sure. Because all of those actually work in conjunction with one another. That is why I tried to describe that in our opening statement of all the different ways that a corporate treasurer has to either raise cash or mitigate risk. Each one of those plays off one another, which is why the only alternative they would have, if those markets start to get shut down or they are shut out of markets or costs are too high, that they just have to have part cash. And that actually has other economic consequences to it.

Mr. STIVERS. Does the impact of these multiple regulatory structures make the United States more or less competitive in global financial markets?

Mr. QUAADMAN. It makes it less competitive. Because the Volcker Rule is a unilateral action by United States, which is why we think there should be international coordination if we are go down that road.

But we have also seen, even with Basel III, while we started to look at the implementing regulations, European regulators were already saying that they had to delay it. So we need to make sure everybody is playing on the same playing field. And that hasn't been the case so far.

Mr. STIVERS. Thank you.

And I guess this question is for Mr. Hambrecht. You talked a little bit about a different solution. But you have experience in the capital markets. I am just curious, do you believe that market making is proprietary trading?

Mr. HAMBRECHT. No, I don't.

Mr. STIVERS. Okay. Whose money is at risk in market making?

Mr. HAMBRECHT. Let me try and answer your question this way: I personally think that trading efficiency has increased enormously because of technology, not because of market makers. So the rise of these so-called dark pools, for example, which are really computer-matching systems, they match the buyer and seller and they take the dealer out of the equation. I think they are the people who have lowered trading costs and equity. And I do think that will happen in debt. This is the BlackRock approach that they have just announced. So, to me, market making the matching the buyer with the seller at the least possible cost.

Mr. STIVERS. And I did that. I worked at the Ohio Company in the 1990s, and I can assure you that it was the Ohio Company's money at risk. It was—its proprietary. Market make the property trading. It is the only example inside of—I agree with Mr. Kelleher, with a lot of everything he said. And I get I will let Mr. Kelleher, and maybe the whole panel tell me if you think—because clearly market making is a company putting their money at risk. To provide liquidity in the markets, they have to offer both a bid and an ask. And they are supposed to make money on the spread. But they have inventory and it is their money at risk.

And does anybody believe that these companies that are market makers don't have inventory and, therefore, their assets are not at risk?

Let me ask it that way, all the way down the panel. A yes-or-no answer is fine with me.

Mr. BARTH. I don't believe that market making is speculative trading.

Mr. STIVERS. I didn't ask if it was speculative trading. I asked if it was proprietary trading. I asked if they had their money at risk, which is the whole point here.

Mr. BARTH. Yes.

Mr. STIVERS. Thank you.

Mr. HAMBRECHT. I would answer it, if they choose so. I think most market makers try to come out flat.

Mr. STIVERS. I agree, but—okay.

Mr. KELLEHER. And much of it is matching. And we put in our comment letters in connection with this rule, showing that, for example, the big banks actually don't keep inventories hardly at all anymore. If you look at the actual facts, they don't. So it is a matching—

Mr. STIVERS. The goal is to not have inventory, I will give you that. The goal is to not have inventory.

Mr. KELLEHER. As a fact, they don't have them.

Mr. STIVERS. Right. They meet their—

Mr. KELLEHER. So there really isn't much proprietary trading left.

Mr. STIVERS. But their goal is to provide, they are in the market to provide liquidity. Therefore, if there is a big short-term imbalance, they could obviously end up with inventory at the end of the day; therefore, they have money at risk. Let's keep going down the panel.

Mr. PLUNKETT. Congressman, I think it is important to note that the Volcker Rule is intended to prohibit proprietary trading, not every instance of principal trading, when banks do take on their books to create inventory in order to have securities that they can sell to asset managers, for instance, or other clients and investors.

Mr. QUAADMAN. I think the regulators are having problems distinguishing between the two, which is why it has been so problematic to even come up with the rule.

Mr. STEVENS. I think Mr. Plunkett hit the nail on the head. It is not so simple a world. There are kinds of principal trading that would be market making, and kinds of principal trading that would be proprietary trading as the Congress sought to address in the provision. And drawing the line between two different kinds of principal trading can be hard.

Dr. HAYWORTH. And the gentleman's time has expired.

Mr. STIVERS. Thank you, Mr. Stevens. My time has expired, but that illustrates how difficult this is. I yield back.

Dr. HAYWORTH. Mr. Green of Texas is recognized for 5 minutes.

Mr. GREEN. Thank you, Madam Chairwoman. I would like to join those in saluting Chairman Bachus for his outstanding work with the committee, and of course, my very dear friend, Ranking Member Frank, for his outstanding service to the committee and to our country.

And I would also like to just mention Mr. Himes, because of some very thoughtful comments he made yesterday on the question of derivatives. Mr. Kelleher, are you of the opinion that

intentionality trumps overt manifestations when it comes to ascertaining whether or not we have proprietary trading versus market making, or are overt manifestations what we look for in the actions of those who engage in these practices?

Mr. KELLEHER. I don't think we need to define the intent of a trader. I think that you can tell by looking at their book and the desk's book, and you check with compliance and risk and capital, and then you look at the bonus pool as it gets rolled up week by week, quarter by quarter, and you can find out exactly what type of trade it was. You don't have to figure out what somebody is thinking in their head as to whether it is proprietary or not. That doesn't mean 100 percent of the time.

Mr. GREEN. Yes, sir, that is just if there is someone who does believe that we have to understand what the person was actually intending to do, as opposed to what the person's overt manifestations indicate.

Mr. QUAADMAN. Mr. Green, if I could just answer, as I said in my opening statement, we believe the capital requirements are actually an easier way to go. One example with the Volcker Rule is the Volcker Rule establishes a bright line of the 60-day period, that if you hold a security for more than 60 days, it is presumed to be proprietary trading.

Now, you can have a company that has hundreds of bonds that may not even move for 90 days. So there is no ability to move, to match a buyer and a seller for a 90-day period. That is not unusual. And in fact, that is not unusual in the stock market either, which is why with the JOBS Act, Congress actually has mandated that the SEC look at whether or not that motivation should be needed for smaller issuances because they can't move over a specific period of time.

Mr. GREEN. I take it from what you have said that it is the actions that really count, not the intentionality?

Mr. QUAADMAN. We think it is difficult for the regulators to define rules that give markets the certainty that they need, and that is why we think that the capital requirements are an easier way to go.

Mr. GREEN. I understand, but you and I seem to be talking past each other. So let me try to focus. If we have a circumstance wherein the actor indicates, yes, I did it, but I didn't intend to do it, are you concluding that this would not be proprietary trading?

Mr. QUAADMAN. I think as the example I used earlier, with the London trade example, the regulators who were embedded in that institution cannot tell you whether or not there was a proprietary trading months after that occurred. And that hasn't been disputed here, so I think that shows exactly why it is almost impossible to define if something is proprietary or not.

Mr. GREEN. Mr. Kelleher, let me allow you to respond, please.

Mr. KELLEHER. In terms of the London Whale, I don't think there is really any dispute, and the dispute, if there is one, comes to the timing of the trade. When the trade was originally put on, it appears from the public record that there was an argument to be made that it was a hedge. It was congruent with an existing portfolio. And the CEO refers to it as kind of ambiguous, but he says it morphed into something else. The truth is, at banks, things don't

morph. People make decisions and then they execute those decisions. And what happened, decisions were made at JPMorgan Chase, to change a highly liquid, low risk, what appears to be an actual hedge, into something that was a straight-out, flat prop trade in a very complex derivative play.

So at the end of the day, what they were in and what they couldn't get out of and what cost them money was a prop trade. I don't have any doubt it is going to come out that way. What it was originally—we don't have the evidence yet because it is not on the public record. It appears that may well have been a hedge, a hedge then and it looks like it would have even been a hedge under the Volcker Rule and the law if it was applicable at the time, but not what it supposedly, what it was changed into.

Mr. QUAADMAN. Mr. Green, if I could just add for one second and maybe this would help is that is one of the reasons why we think there should be a reproposal, because you have had this proposal out there for so long. The regulators have asked so many different questions. It is important, I think, for everybody that if they can repropose the rule, allow everybody to take another look at it, determine whether or not there is turnkey there, then we can figure out if it needs to be fixed or not.

Mr. KELLEHER. There were 18,000 comment letters, something around 2,000 meetings, 99 percent of them with industry. They need more input? And I will note for the record, anyway, because the answer was that Mr. Quaadman agrees with me and you, and when it comes to proprietary trading, actions will tell you what you need to know.

Dr. HAYWORTH. And the gentleman's time has expired. Thank you, Mr. Green.

Mr. GREEN. Madam Chairwoman, I yield back.

Dr. HAYWORTH. Thank you, Mr. Green. Mr. Huizenga is recognized for 5 minutes.

Mr. HUIZENGA. Thank you, Madam Chairwoman, and at this point, I would like to actually turn it over to my good friend and colleague from Texas, Quico Canseco, for the balance of my time.

Dr. HAYWORTH. The gentleman yields to Mr. Canseco.

Mr. CANSECO. Thank you. Thank you for yielding. Mr. Barth, I want to pick up where we left off, and as I understand the way the rule is currently drafted, it says that a firm could not make money if an asset they hold increases in value after they acquire it. So a firm would have to have no incentive whatsoever to acquire an asset that is priced very low. Wouldn't that add to systemic risk in the financial system, especially in a time of crisis when asset values plummet?

Mr. BARTH. Yes, asset values, indeed, do fluctuate a great deal over short periods of time, and that is, in my view, a problem with the Volcker Rule. It talks about a relatively short period of time, in which the intent is to gain from the price increase rather than serve a customer. I think that is the problem.

I think there is still difficulty despite what some other people believe about the Volcker Rule. May I just add, if one is worried about too-big-to-fail, the issue is capital. If institutions have too little capital, of course, they could have a lot of assets. So I think capital requirements, liquidity requirements, are a way to deal with

too-big-to-fail. I don't think the Volcker Rule is a way to deal with too-big-to-fail.

Mr. CANSECO. So you mention in your testimony that you believe that the Volcker Rule is based on an incorrect premise, or an incorrect assumption. Why is it an incorrect premise, and is there anywhere where the Volcker Rule can be implemented that would avoid problems in the future?

Mr. BARTH. I think I, perhaps, should say, is, or may be an incorrect premise. And the reason I say that, based upon the hearings that were held earlier this year, there was talk about the fact that many people now are willing to concede the fact that the proprietary trading was not the cause of the financial crisis, which was severe in the United States. And nobody has presented any evidence suggesting that of all the costs associated with the crisis, proprietary trading accounted for a large proportion of those costs.

Now, the concern that is going forward in the future, it is speculative, in my view. What is really speculative is to say that the Volcker Rule is going to prevent a future crisis. I think that is sheer speculation. There is no evidence whatsoever, based upon its role in the previous crises in this country or any other country around the world.

Mr. CANSECO. Do you believe that if other countries do not implement a Volcker-like rule, then trading that would be prohibited in the United States will move overseas?

Mr. BARTH. Yes, I think that is a distinct possibility. I know Mr. Kelleher did talk about the Liikanen Report, and the Vickers Report, and one might describe them as "Volcker Light," but clearly, I do not believe that the solution to the future crises is the Volcker. And indeed, I think business could migrate across national borders, go into other countries. And that would be a concern for U.S. banks in terms of the competitiveness.

Mr. CANSECO. Thank you, Professor. Mr. Quaadman, there are reports that regulators could potentially come out with three different versions of the so-called Volcker Rule. Could you comment on the confusion that would result if that were the case?

Mr. QUAADMAN. Let me give you one example. We took a group of corporate treasurers up to meet with all the regulators involved in the Volcker Rule earlier this year, and the day literally started with one regulator saying, we are going to look at this by trade-by-trade analysis, and we ended the day with the regulators saying, if you develop principles and you are in conformance with the principles, you are going to conform with the rule, you are going to be compliant with the rule. They are talking about the same rule.

What I think is important here is, I think we need to have a rule that works. We need to have regulators on the same page, and we are not getting there. That is one of the reasons why last year, actually a year ago now, we sent a letter in just on cost-benefit analysis, because you had five regulators with five different legal standards, and we thought they should conform to the economic analysis and rigorous economic analysis that was proposed by President Obama in Executive Order 13563 so that they were all looking at it in the same way.

And unfortunately, as this Volcker Rule consideration has continued on, we are just seeing divergence instead of convergence, and unfortunately, a system that may not work.

Mr. CANSECO. Thank you very much. I yield back the balance of my time.

Dr. HAYWORTH. Thank you, Mr. Canseco. Mrs. Maloney of New York is recognized for 5 minutes.

Mrs. MALONEY. I thank all of the panelists. I would like to put in the record a series of articles that points out how proprietary trading was really prosecuted, and some of our most respected banks had to pay fines of over $500 million for what was described as an abuse, knowingly selling to their customers products that they knew were faulty, and then shorting them.

So how you say that is not part of the financial crisis, I beg to differ. There are many parts of the financial crisis. The subprime crisis was part of it. But those who took those instruments, those subprime documents and then sold them to their trusted clients, causing their loss and making a profit, is not a policy that I would like to see continued in our great country. I think markets run on trust, and we have to restore the trust of our great country.

I would like to say that I would like to place into the record a list of banks that have voluntarily given up proprietary trading, conforming to the Volcker Rule before it takes effect. I wrote both the Federal Reserve, and the OCC asking, what is the status of the Volcker Rule? What are our banks doing? The OCC wrote back and said that six of the largest banks in our great country are already adhering to the Volcker Rule. And these institutions are Citibank, JPMorgan Chase, Bank of America, Wells Fargo, and PNC Bank.

I have not heard from the Federal Reserve, even though I wrote my letter in September, they haven't gotten back to me. But they have unwound, they have the trading moved off. They are no longer doing proprietary trading in many of the banks in the district that I am privileged to represent. So it is being taken seriously by the financial sector and financial leaders of some of our major institutions. They are adhering to it.

I have three major points that I would like to put in the record for this purpose of the hearing on the Volcker Rule. And some of you have underscored them. First, a stable financial system with robust financial markets can only exist with clear comprehensible rules of the road. And as proposed, the regulations implementing the Volcker Rule would not follow this simple principle of clarity. The complexity of the regulatory proposals to implement the Volcker Rule must not be carried forward into its final form. Many of you have talked about the complexity. It has to be very clear to the market, and I believe that our regulators can do it.

Second, the five agencies responsible for implementing this rule should resolve their differences and put forward a consistent set of regulations. Several different and potentially conflicting sets of expectations could leave the American financial industry in total disarray, an outcome that is both undesirable and unnecessary. So I speak to the regulators that they have to be coordinated on this.

And finally, our regulators must remain mindful of the important exceptions that Congress clearly provided in the Volcker Rule for market-making and hedging activities for the purpose of helping

their clients. In respect to market making, Congress understood that adequate liquidity is absolutely essential to well-functioning financial markets, and banks play an essential role in providing that liquidity.

Banks must have clear authority to engage in customer-related trading in order to make markets and strong U.S. financial markets so critical to growing companies and our economy and our jobs. And also, the hedging is also an essential tool that financial institutions use to safely manage their exposure and ultimately, to protect the American investors and depositors.

So I wanted to talk about that, and the one person's testimony that I didn't hear—I had to go testify at the Transportation Committee—was Mr. Stevens. So I want to point out that when the Senate added the Volcker Rule to Dodd-Frank, it did not come out of this body, but the Senate added it. The clear intent was to limit a bank's ability to sponsor or invest in hedge funds and private equity funds. And Mr. Stevens, can you describe some of the key consumer protections that are different from registered mutual funds and from the kinds of entities that the Volcker Rule is intended to prevent banks from—

Dr. HAYWORTH. The gentlelady's time has expired. Mr. Stevens, can you answer very quickly? I apologize for that.

Mr. STEVENS. In very simple terms, we are subject to a very comprehensive scheme of regulation under all the Federal securities laws. The hedge funds are subject to none of that.

Mrs. MALONEY. Very briefly, may I say one thing?

Dr. HAYWORTH. Mrs. Maloney, your time has expired. We want to get to Mr. Carney if we can.

Mrs. MALONEY. Oh, sorry.

Dr. HAYWORTH. Mrs. Maloney's documents will be entered into the record, without objection.

Mr. Carney is recognized for 5 minutes.

Mr. CARNEY. Thank you, Madam Chairwoman. I thank the panel for coming today. I have been fascinated by this discussion, and a little confused by some of it. We have a vote, so I will try to be quick. I want to come back to Congressman Stivers' line of questioning around the distinction between proprietary trading and market making.

Mr. Kelleher and, I think, Mr. Hambrecht, I believe you both believe that it is pretty simple to determine that, and that you don't really need to look at intent. But doesn't the proposed rule call for a plan that the entity would submit and describe what their intent would be in these kinds of practices? Isn't that what the proposed rule suggests?

Mr. KELLEHER. I don't believe so, but even if one were to argue, and many have argued that is what it does require, there is going to be a final rule and there are several ways—we filed four separate comments letters on this suggesting—

Mr. CARNEY. So your view is, you don't have to focus on intent. You can do it by looking at the compensation, deconstructing the compensation package?

Mr. KELLEHER. And the economic interest at the time. I am told by people who make a living, an incredibly good living trading and

running desks at the biggest banks in this country, that this is not a complex problem.

Mr. CARNEY. It is not a hard problem.

Mr. KELLEHER. It is pretty clear at the time.

Mr. CARNEY. The complaints that I have heard from market participants is that it is a distinction between a permitted activity, market making, and a prohibitive activity, prop trading. Clearly, prop desks, and all that, they have been eliminated. That is easy. But holding, buying securities to hold and to sell later, is much more difficult to determine, but you don't think so?

Mr. KELLEHER. Even for market making, the traders and the desk that the traders work for, all have allocations as to how much risk they can take on for the firm. So they are not willy-nilly trading in terms of market making. They know it and are tracking it minute to minute. The other thing at a macro level, any bank can do all of the market making they want. All they have to do is run basically a hedged book, or a flat book. Even a hedged book, a legitimately hedged book, you can do all of the market making and anything you want.

The other thing is and we laid this out in the comment letters, much of the complaints about the need for inventory, particularly in the derivative space, there is no evidence that the banks are keeping that inventory anyway today, never mind tomorrow. So when you actually look at the facts as opposed to the claims, the application of the rule to the actual market making activities that they claim to engage in, either are actually being done at a very low level and can be done relatively easily in compliance with the law.

Mr. CARNEY. So you don't think it is big—Mr. Hambrecht, your view of that?

Mr. HAMBRECHT. I agree with Mr. Kelleher. I think it is normally very clear what the goal of making a market is. And if it is to keep an orderly market and to keep basically the right to get most of the order flow, as it is for most specialists, there is an obligation to put out some capital to keep an orderly market. But that is always based on the premise that you are going to move the stock along.

Mr. CARNEY. It will be as obvious to the regulator as it is to the manager of the—

Mr. HAMBRECHT. Oh, yes, I think the idea that regulators can't figure it out just isn't true. We deal with the SEC all the time. They know how capital markets work.

Mr. CARNEY. Fair enough. So what about Mr. Quaadman's notion that we should approach it through capital requirements as opposed to prohibitions, I guess?

Mr. HAMBRECHT. My position would be any exemption you give should have additional capital requirements or margin requirements placed on them as an added safeguard.

Mr. CARNEY. So you don't dismiss it as an effective tool?

Mr. HAMBRECHT. No, I think it is an added safeguard that someone can't build these massive positions and suddenly people find out about it when it is too late.

Mr. KELLEHER. Capital has to be a complement to the other rules.

Mr. CARNEY. Right. Fair enough. So one more question about that. What would you say to Mr. Quaadman's concerns about the company treasurers, and what they would have to do with respect to holding more capital, given the various rules and regulations that are coming down?

Mr. HAMBRECHT. Oh, I think it has very little effect on cash balances in a corporation. That is much more a function of taxes and future needs of capital. I think, basically, most corporate treasurers would tell you that the technology that has been brought into markets today has made transaction costs come down significantly, and that they can raise money now on a much lower cost. Equity trading has gone from what used to be anywhere from 1 to 5 percent, down to 10 percent of 1 percent. And that will happen in the debt markets.

Mr. CARNEY. Thank you very much to the whole panel. I found your testimony very helpful.

Dr. HAYWORTH. And the gentleman's time has expired. The Chair thanks the panel for their testimonies.

The Chair notes that some Members may have additional questions for the panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

The hearing is adjourned.

[Whereupon, at 11:22 a.m., the hearing was adjourned.]

A P P E N D I X

December 13, 2012

Rep. Peter King: Statement for the Record, Dec. 13, 2012

FSC Hearing: "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Part II"

Mr. Chairman, thank you for calling today's hearing. The Volcker Rule, enacted as a part of the Dodd-Frank Act, carries significant implications for my home state of New York as well as for the national economy and U.S. financial markets. The complexity and cost of this rule is evident in the regulators' 298-page proposal, which elicited some 18,000 comment letters and would require some 6.2 million private sector man-hours to achieve compliance. Furthermore, there is no date certain for finalization – so businesses are left guessing what activities will be prohibited and which will be deemed appropriate, and when.

If Volcker is put into place as currently written, it could sap market liquidity, depress the value of pension plans and retirement accounts, make it costlier for state and local governments to raise funds, and place U.S. financial firms at a competitive disadvantage with foreign counterparts. It could even jeopardize New York's role as the financial capital of the world, which would carry economic repercussions well beyond the state.

To address some of the many concerns regarding the Volcker Rule, I introduced the *U.S. Financial Services Global Viability Act (H.R. 6524)*. My legislation would suspend enforcement of the Volcker Rule at least until other international competitors have adopted similar statutory restrictions. As many here are well aware, the Volcker Rule prohibits proprietary trading, but as written will likely have the unintended consequence of preventing U.S. firms from engaging in market-making and underwriting activities for their customers. This will place the U.S. at a competitive disadvantage in a global financial marketplace – causing capital and certain trading operations to move offshore. To prevent this potential harm to the American economy and to provide for a level international playing field, the enforcement of the Volcker Rule should, at a minimum, be suspended until other international competitors have adopted and are abiding by similar statutory rules.

The Volcker Rule was originally conceptualized for adoption on an international scale. But while other nations' regulators balked at putting it into place, Section 619 of the Dodd-Frank Act applies it to a wide range of U.S. financial institutions. Any insured bank or bank holding company, as well as nonbank financial companies regulated by the Federal Reserve, will be burdened with this new level of compliance. With our economy still struggling to regain its footing, this is not the time to give businesses a reason to cut their U.S. workforce or move investments to foreign competitors overseas.

United States House of Representatives
Committee on Financial Services

Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation, Part II

Written Testimony by James R. Barth, Lowder Eminent Scholar in Finance, Auburn University; Senior Finance Fellow, Milken Institute; and Fellow, Wharton Financial Institutions Center

December 13, 2012

Chairman Bachus, Ranking Member Frank and members of the committee, thank you for the opportunity to testify today on section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, also known as the Volcker Rule. I would like to note that my testimony is not offered on behalf of any institutions that I am affiliated with but represents my own view.

My opinions are based on my experience as an academic studying financial institutions and markets and as an official at bank regulatory agencies. I am now on the faculty at Auburn University and previously was on the faculty at George Washington University. In addition, I have served as director of the Office of Policy and Economic Research of the Federal Home Loan Bank Board and chief economist of the Office of Thrift Supervision. I have also held positions as visiting scholar at the Congressional Budget Office, the Federal Reserve Bank of Atlanta, the Office of the Comptroller of the Currency, and the World Bank. In my scholarly research and government service, I have studied the performance of hundreds of financial institutions, including the causes of distress for many that failed. In addition, I recently published several articles and books on financial crises, their causes, and their lessons.

The Volcker Rule prohibits banking entities from engaging in proprietary trading activities and limits their ability to invest in, or have certain relationships, with hedge funds and private equity funds. Certain activities are exempted from these prohibitions subject to prudential backstop provisions. The rule's purpose is to prohibit activities that could create excessive risks for banking entities and conflicts of interest.

I believe the Volcker Rule is based on an incorrect premise, will be extremely difficult to implement, and, worse, will produce harmful economic effects.

There is no evidence to support the belief that proprietary trading was a cause of the recent or any other financial crisis. In fact, all the evidence points to the contrary. The most recent crisis was triggered by poor lending and underwriting practices in the real estate sector, and excessive leverage by and insufficient liquidity at banking entities, not by proprietary trading by banks.

The implementation of the Volcker Rule will require regulators to distinguish between prohibited proprietary trading and permissible activities such as market marking, hedging, and underwriting on behalf of customers. Because these permissible activities sometimes appear similar to proprietary trading, it may be virtually impossible for regulators to draw a bright line between the prohibited and permissible activities that is not arbitrary. To the extent that regulators err on the side of restricting beneficial trading activities, or that the regulation deters banks from engaging in some permissible activities, the result will be banks providing less liquidity in the market. This, in turn, will increase the bid-ask spread on securities: Issuers will pay higher interest rates in the primary market to raise capital, and investors will pay more to purchase securities and receive less when selling them in the secondary market. All these developments harm markets, businesses, investors, and job creation.

As banks are denied the opportunity to engage in profitable trading activities, they may be driven to engage in ever more risky activities in an attempt to provide investors with an acceptable return. The Volcker Rule may therefore lead to riskier, not less risky, banks. The rule may also place U.S. banks at a competitive disadvantage to banks in other countries. In addition, the rule—while attempting to limit risk-taking at banks—may shift this risk-taking to less-regulated parts of the financial system that are less resilient should losses arise.

Let me elaborate on this last point. The January 2012 Report of the Financial Stability Oversight Council notes that even before the rule has been imposed, "major banking entities have taken or announced steps to sell, spin off, or close down their standalone 'bright line' proprietary trading businesses." What will happen to these proprietary trading businesses? They will be conducted at non-banks. This seems to be starting already. The media has reported on proprietary traders moving from banks to non-banks and to hedge funds in particular, with headlines like "Banks move high risk traders ahead of U.S. rule" (Reuters), "Billion-Dollar Traders Quit Wall Street for Hedge Funds" (Bloomberg), "Deutsche Bank Head Debt Trader Cornut Leaves for Hedge Fund" (Bloomberg) and "Traders flee big-bank regulations to start own hedge funds" (New York Post).

If proprietary trading simply carries on at hedge funds and other non-banks including non-financial firms, the question then becomes: Is the forced migration of proprietary trading from banks to non-banks more likely to increase or decrease financial stability? To address this issue, I recently conducted a preliminary examination of 22 years of very large individual trading losses with Donald McCarthy, an economist based at Econ One Research. We found that these trading losses were in no way limited to banks or financial services firms. Rather, they occurred at a range of firms, including banks, investment banks, hedge funds, and manufacturing firms. Even a local government authority was involved. We also found that these individual losses at banks —while as large as or larger than losses at non-banks —were smaller by far as a share of equity capital. That is, the losses at banks were less threatening to solvency than the losses at non-banks.

This raises the possibility that instead of increasing financial stability, the Volcker Rule may actually decrease financial stability by shifting risk-taking activities from banks, which by and large have been more successful at absorbing the trading losses identified, to non-banks, which have been much less successful at absorbing losses, judging by our examination of the past several decades.

Since 1990, we identified at least 15 instances when individual traders lost at least $1 billion (in 2011 dollars). These 15 trading losses totaled nearly $60 billion and ranged from a low of $1.1 billion on ill-fated foreign exchange derivatives at a Japanese Shell Oil subsidiary to a high of $9 billion on credit default swaps at Morgan Stanley. News coverage of trading losses tends to focus on their size; and it is this information that I present in Table One.

It should be noted that just four of the 15 firms were banks: Société Générale, JPMorgan Chase, Union Bank of Switzerland (UBS), and Deutsche Bank. The rest were non-banks. Two were investment banks (Morgan Stanley, which became a bank the year after the loss, and Barings Bank); two were hedge funds (Long Term Capital Management and Amaranth Advisors); and one was a local government (Orange County). Fully six of the 15 were manufacturing or petrochemical firms: Sumitomo Corporation (a Japanese diversified industrial conglomerate), Aracruz Cellulose (a Brazilian wood pulp processor), Kashima Oil (a Japanese oil refiner), CITIC Pacific (a Chinese diversified industrial conglomerate), Metallgesellschaft (a German manufacturer), and Showa Shell Sekiyu (a Japanese oil refining subsidiary of Shell).

Table One
Magnitude of Trading Losses
Absolute Losses 1990 - 2012

Name of Company	Type of Company	Year of Loss	Size of Loss (2011 Dollars) (Millions)	Share of Total
(1)	(2)	(3)	(4)	(5)
1. Morgan Stanley	Investment Bank	2007	$ 9,605	16%
2. Société Générale	Bank	2008	7,546	13%
3. JP Morgan Chase	Bank	2012	7,500	13%
4. Amaranth Advisors LLC	Hedge Fund	2006	6,567	11%
5. Long Term Capital Management	Hedge Fund	1998	5,828	10%
6. Sumitomo Corporation	Manufacturer / Oil refiner	1996	3,544	6%
7. UBS	Bank	2011	2,300	4%
8. Aracruz Celulose	Manufacturer / Oil refiner	2008	2,224	4%
9. Orange County	Government	1994	2,127	4%
10. Kashima Oil	Manufacturer / Oil refiner	1994	2,127	4%
11. Barings Bank	Investment Bank	1995	2,028	3%
12. CITIC Pacific	Manufacturer / Oil refiner	2008	1,983	3%
13. Metallgesellschaft	Manufacturer / Oil refiner	1993	1,882	3%
14. Deutsche Bank	Bank	2008	1,879	3%
15. Showa Shell Sekiyu	Manufacturer / Oil refiner	1993	1,520	3%
			58,661	

Sources: Press reports, company annual and quarterly reports.

It is perhaps surprising that almost half the losses by individual traders were not at financial services firms but at the types of institutions that typically are thought to use financial products not for speculation but for hedging purposes with very little risk. However, in both the number of trading losses and the size of these losses, non-financial firms loom large. In terms of total losses, 26 percent occurred at manufacturing or petrochemical firms or local governments, and 74 percent occurred at financial services firms. Of this 74 percent, 33 percent of losses occurred at banks, 21 percent at hedge funds, and 20 percent at investment banks. The losses of non-financial firms tended to be smaller in absolute terms than the losses of financial services firms. Yet, it is quite clear that the trading problem is not limited to Wall Street or the City of London; Main Street firms are at risk of trading losses as well.

While the magnitude of these losses is staggering, some perspective is appropriate. Trading losses that risk eroding a firm's capital in its entirety are more important—to the institution, to other market participants, and (in the case of banks) to the federal deposit insurance fund or to taxpayers—than bigger losses at larger and better-capitalized firms. Other things being equal, a better-capitalized institution can sustain bigger trading losses, so it is less likely to fail and impose costs on counterparties, taxpayers, and (in the case of systemically important institutions) the financial system in general and perhaps on the economy as a whole.

Table Two
Magnitude of Trading Losses
Relative Losses 1990 - 2012

Name of Company	Size of Loss (2011 Dollars)	Loss as Share of Percent of Assets	Percent of Equity	Percent of Tier 1 Captial
	(Millions)		(Percentage)	
(1)	(2)	(3)	(4)	(5)
1. Morgan Stanley	$ 9,605	0.9%	28.8%	26.2%
1. Société Générale	7,546	0.4%	12.0%	15.4%
2. JP Morgan Chase	7,500	0.5%	6.1%	8.5%
3. Amaranth Advisors LLC	6,567	65.0%	260.0%	n/a
4. Long Term Capital Management	5,828	3.4%	93.6%	n/a
5. Sumitomo Corporation	3,544	5.2%	n/a	n/a
6. UBS	2,300	0.1%	3.6%	5.3%
7. Aracruz Celulose	2,224	19.1%	52.0%	n/a
8. Orange County	2,127	7.3%	19.7%	n/a
9. Kashima Oil	2,127	n/a	n/a	n/a
10. Barings Bank	2,028	n/a	298.7%	n/a
11. CITIC Pacific	1,983	16.8%	36.9%	n/a
12. Metallgesellschaft	1,882	13.0%	n/a	n/a
13. Deutsche Bank	1,879	0.1%	4.0%	3.9%
14. Showa Shell Sekiyu	1,520	13.2%	66.2%	n/a

Sources: Press reports, company annual and quarterly reports.

Table Two presents the same 15 trading losses from a different perspective. In addition to the absolute magnitude of the losses, they are presented relative to the total assets, equity, and—for banks—tier one (core) capital the institutions had at the time the losses were recognized. Both equity and tier one capital are measures of a firm's ability to absorb losses without being pushed into insolvency, which occurs when the value of a firm's total assets is less than the value of its total liabilities. When a firm has a large equity cushion, other things being equal, it is more able to absorb trading losses. Tier one capital essentially consists of equity and retained earnings less certain types of intangible assets. Regulators in the United States and abroad set capital adequacy standards based on tier one capital and monitor the ratio of a bank's tier one capital to total assets. Seen through this lens, the losses at banks appear less worrisome than those at non-banks.

Three of the 12 firms for which we have information about their equity suffered individual trading losses of at least $1 billion nearly equal to or greater than their equity cushions. All three were non-banks (hedge funds Amaranth Advisors and LTCM and investment bank Barings Bank), and all three either failed or were bailed out. LTCM was bailed out by a government-arranged consortium of its trading counterparties, while Amaranth Advisors arranged a transaction whereby JPMorgan Chase and hedge fund Citadel Investment Group took over its energy portfolio and then liquidated

the rest of its holdings—a failure in form if not in name. Barings Bank—one of the UK's oldest financial institutions at the time—was allowed to fail by the Bank of England, and administrators were called in to dispose of its assets.

All of the remaining firms for which we have information about their equity suffered losses smaller than their equity cushions. Four of the nine had losses of 25 percent or more of equity, and two had losses between 10 percent and 25 percent of equity. All four institutions with losses of 25 percent or more of equity were non-banks: Showa Shell Sekiyu, Morgan Stanley, Aracruz Celulose, and CITIC Pacific. All survived, however, with the possible exception of Japanese oil refiner Showa Shell Sekiyu, although each was forced to seek additional funding from outside investors to rebuild its capital or to seek capital from its parent corporation.

Of the two institutions with losses between 10 percent and 25 percent—Orange County and Société Générale—one failed. Orange County suffered bankruptcy despite the fact that its counterparty in the ill-fated trades—Merrill Lynch—loaned Orange County $2 billion of a $2.5 billion credit line after the losses. Société Générale was the only bank to suffer an individual trading loss of this magnitude relative to its capital, and it increased its capital by some 5.5 billion euros (more than $8 billion) after the discovery of the losses by issuing additional rights to stockholders at a steep discount to the market price.

The remaining three institutions—JPMorgan Chase, UBS, and Deutsche Bank—suffered losses of less than 10 percent of equity. JPMorgan Chase's losses, while vast, were not large enough relative to its equity cushion to present a solvency problem and did not compel the bank to raise additional capital. Similarly, the huge losses at UBS were substantially less than its equity capital and presented no solvency problem for the Swiss banking giant. Thus, while the Swiss Financial Market Supervisory Authority (in conjunction with the U.K.'s Financial Services Authority) initiated formal administrative enforcement proceedings against UBS in February, the focus was on "assess[ing] ... the adequacy of the controls that were in place to prevent and detect unauthorized trading," and UBS has not been required to raise additional capital. Deutsche Bank's losses also presented no solvency problems and did not require it to raise additional capital. In addition, the "tier [one] capital ratio [to risk weighted total assets] of the bank has remained at over 10%" in 2008, according to its financial statements. As with UBS and JPMorgan Chase, the losses primarily presented an earnings problem for the bank, which lost 5.7 billion euros in 2008 before taxes (about $8.4 billion).

Table Three compares the relative magnitude of the individual trading losses identified at particular types of firms to the relative magnitude of losses in general for the period 1990–2012. It is no surprise that the banks' losses, accounting for 0.2 percent of total assets and 5.3 percent of their equity, posed relatively little risk to solvency. Investment banks are considerably riskier with losses equal to 0.9 percent of total assets and 34 percent of equity. This suggests that the leverage of the investment banks experiencing losses between 1990 and 2012 was considerably higher than that of the banks with losses over the same period.

It may surprise critics of the financial services industry that the next most risky firms in terms of solvency are manufacturing and petrochemical firms—firms that typically are end-users of derivatives and other financial products. However, this class of institutions experienced average losses of 9.5 percent of total assets and 47.9 percent of equity. Unlike investment banks that lost money, the issue is not clearly one of leverage, but of the size of the losses relative to both total assets and equity of the firms. Finally, the most risky are hedge funds, which experienced losses equal to 7 percent of total assets and 140 percent of equity. The issues would appear to be largely one of debt for LTCM, which was leveraged about 25 times, and one of the size of losses relative to total assets for Amaranth Advisors, which was leveraged just four times.

Table Three
Magnitude of Trading Losses
Relative Losses 1990 - 2012

	Size of Loss (2011 Dollars)	Share of Total Losses	Losses as Share of Total Assets	Losses as Share of Net Equity
	(Millions)			
Bank	$ 19,225	33%	0.2%	6.5%
Hedge Fund	12,395	21%	6.8%	141.6%
Investment Bank	11,633	20%	0.9%	34.2%
Manufacturer / Oil refiner	13,281	23%	9.5%	47.9%
Government	2,127	4%	7.3%	19.7%
Total	$ 58,661	100%	0.6%	14.2%

Sources: Press reports, company annual and quarterly reports.

Table Three should give pause to those who believe the Volcker Rule will enhance our country's financial stability. Trading appears to be less risky when carried out at banks than at non-banks. The important point of this exercise, however, is that one should not focus on trading losses per se, but on potential trading losses relative to equity capital, which reflects a firm's ability to absorb losses. Excessively leveraged firms are clearly less able to absorb trading losses—or any losses, for that matter. Moreover, some large trading losses did occur during the financial crisis, but mortgages

based on poor lending and underwriting quality were largely to blame rather than the trading itself. And the most leveraged firms suffering these losses were in the greatest jeopardy of insolvency.

The focus of regulation should therefore be on ensuring that banking entities have sufficient capital commensurate with their risk, not on separating some investment bank activities from commercial banking.

Furthermore, as noted earlier, proprietary trading per se was in no way the cause of the last financial crisis, nor was it the cause of any financial crisis in the United States or abroad of which I am aware. The more regulators prohibit or limit banking activities, the more they may create incentives for these activities to move to non-banking firms. In addition, such regulations may make banks less profitable and more willing to engage in other more risky activities. This may well have the effect of making banks less sound and decreasing overall financial stability.

In conclusion, I see very little, if any, upside to the Volcker Rule, but substantial costs to markets, businesses, and investors. That the rule is well-intentioned and banks may survive it is not the issue. The issue is whether the benefits exceed the costs. There is no evidence that this is the case, and my reading of the evidence is to the contrary. It is therefore difficult to justify such a major organizational change in banking.

WRHAMBRECHT+CO

December 11, 2012

Spencer Bachus, AL, Chairman
Barney Frank, MA, Ranking Member
U.S. House of Representatives
Committee on Financial Services
Washington, DC. 20515

Dear Sirs,

Thank you for your invitation to testify at the hearing, "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Part II" on Thursday, December 13, 2012.

I was a member of the Investors' Working Group, an independent taskforce sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, which was co-chaired by Arthur Levitt and William Donaldson. The committee was founded in 2008 and submitted its report in July 2009. Our report recommended imposing careful constraints on proprietary trading at depository institutions and their holding companies. "Proprietary trading creates potentially hazardous exposures and conflicts of interest, especially at institutions that operate with explicit or implicit government guarantees."[1] When the committee was disbanded, I was asked to respond to questions about proprietary trading and provide continuity to interested parties.

The Volcker Rule

The Volcker Rule was first proposed in the wake of the Financial Crisis of 2008, and called for a direct ban on proprietary trading. However, as the crisis began to subside, the proposal's inclusion in the Dodd-Frank Act was changed to allow banks to continue proprietary trading with defined limitations. Its intent, or course, was to limit the major banks from engaging in speculative trading that would endanger customer deposits or accounts; and in particular, limit the bank's scope of trading and any systemic risk that would create a "too big to fail" crisis.

The subsequent debate and inclusion of exemptions has led to much inquiry on how to define certain aspects of the Act. At the most basic level, the vital question is whether a trade is providing liquidity to the marketplace to help a client, or whether it is a proprietary trade. In today's environment of sophisticated derivative instruments and algorithms, this question is incredibly difficult to answer. Congress has expended great effort to limit systemic risk from proprietary trading, yet still keep as much liquidity as possible in the current market system.

The Volcker Rule permits a number of client-oriented trading by banking entities. But those so-called "permitted activities" are also subject by the statute to additional capital charges, leverage limits, or other restrictions as the regulators deem appropriate. My testimony today will focus on how to improve The Volcker Rule by enhancing and clarifying the role of restrictions on leverage.

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[1] *U.S. Financial Regulatory Reform: The investors' Perspective* (A Report by the Investors' Working Group, Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, July 2009) page 3

Financial Crisis

The repeal of The Glass-Steagall Act in 1999 allowed for the combination of Investment Banks and Commercial Banks. Significant consolidation followed and in 2002, these broker-dealers were allowed by the Securities Exchange Commission to increase their leverage from 12-13x to 30x the value of their equity, a freedom that no other financial institution was afforded. The leverage limits were regulatory guidelines, not statutory requirements, as the existing net capital rules allowed almost unlimited leverage. This increase in large part led to a catastrophic financial failure felt the world-over in 2008.

While the Financial Crisis of 2008 had far-reaching and deleterious effects throughout virtually every level of the global economy, the epicenter of the crisis itself was largely confined to six "bulge" broker-dealers: The Bear Stearns Companies, Inc.; Citigroup, Inc.; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Lehman Brothers Holding Inc.; and Morgan Stanley. In the wake of this crisis, two of the above broker-dealers failed, three came perilously close to failure, and one had a strong enough commercial bank balance sheet to weather the storm. Today, they are all bank holding companies, some with significant depository banks within the group.

Also caught up in the wake of this crisis were literally hundreds of hedge funds, broker-dealers, and commercial banks, which although sorely wounded, survived the bubble with minimum or no government support. Because of the existing market discipline on these "small enough to fail" firms, there were no failures that threatened the financial system as a whole.

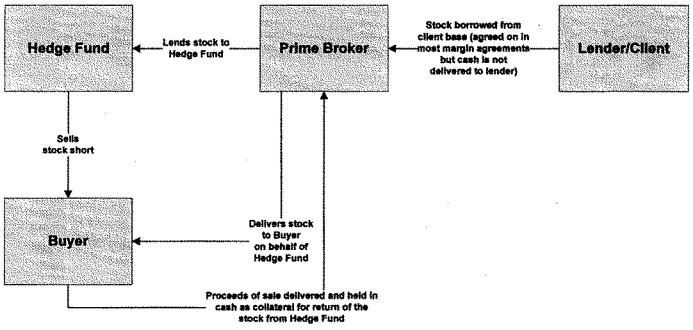
The Key to Almost Unlimited Leverage – The Broker-Dealer Exemption

Broker-dealers liquidity is measured by a daily Capital Adequacy Rule which is designed to limit capital commitments. They are allowed to net-out their longs and shorts to calculate their net capital requirements on the assumption that as market makers, they are providing liquidity to the market. As such, they are exempt from normal margin rules that control the leverage of other active trading hedge funds and individuals. This "dealer exemption" created a vehicle that allowed almost unlimited leverage and the dealer's ability to borrow stock from his customer base gave him an extremely low cost of capital. In practice, however, even though they had to get "down" to 30x leverage by market close, many traded up to 3 or 4 times that during the course of the trading day, which provided a substantial loophole as capital adequacy is calculated at the end of the day. During the financial crisis of 2008, these enormous capital risks were rationalized by hedges of large short positions that were assumed to act rationally, but in reality seldom do in a crisis environment.

A great deal of trading today has moved to so called "dark pools" which are essentially providing a "matching" platform for buyers and sellers. While it is difficult to find reliable data, we estimate that specialist trading has ranged from 3-9% of total volume, and bulge firms now account for 25-30% of dark pool trading in competition with customer matching orders. Agency fees have fallen to 10-20 mils per share, indicating that equity trading is a very competitive market. Debt and other instruments have much less transparency, so it is difficult to estimate volumes, but the recent Blackstone announcement of a crossing system for debt suggests the same kind of matching platforms will add to liquidity and competitiveness in debt markets.

The Key to "Free" Money and Leverage – The Prime Brokerage Business

Most of the 6 broker-dealers that were seriously affected during the financial crisis were major players in the "prime brokerage" business. Since most hedge funds are short sellers to protect against major declines, these prime brokers were the overwhelming beneficiaries of the credit balances created by short sales.



The process described above created cash balances at the prime brokerage that effectively helped finance the broker-dealers' massive trading accounts without paying interest and without any lender discipline. The remaining cash needed to finance these accounts came largely from the repo market and overnight loans. These loans are largely governed by balance sheet scale and are generally made only to the very large banks.

Both sources of cash are subject to little lender discipline and as such, at any signs of trouble, the market shuts down quickly. In this case, the repo market will "dry up" after the morning repayment, and the hedge funds will move their accounts to a "safer" home, forcing the prime broker to return the collateral cash when the short position is moved to another broker.

This constitutes a proverbial "run on the bank," not by commercial bank depositors, but by hedge funds and repo lenders. This is why the CEO of Bear, Stearns In February 2008 could claim over $20 billion of cash at the start of the week, and have virtually run out of cash by the end of the same week (see Exhibit 1, Lehman Brothers and Bear, Stearns Balance Sheets).

Non-Transparent Markets – Where the Market Fails

In a normal market environment, when leverage reaches a certain threshold, the owner of the trading position is forced to liquidate or reduce his position and pay off the lender. In the 2008 financial crisis, this did not occur as the mortgage securitization market was on over-the-counter market dominated by a small number of firms where tacit cooperation and self-interest among traders led to markets being maintained at unrealistic valuation despite the underlying assets of the mortgage securities steady decline.

Dealers when acting as specialists on an exchange platform must abide by specialist rules that generally include an obligation to maintain a market in difficult environments. In a dealer market off the exchange, there are no such obligations and a combination of order flow knowledge and profit incentives for traders, generally means that traders move in front of or with trading direction. Instead of providing liquidity against flow orders, in practice they add to the volatility.

In the case of OTC trading in securitized products and swaps, by the time that the risk was identified, there was no one in the marketplace willing to buy the positions, and therefore, the traders tried to hold pricing levels in the hope that other firms or funds would step in and purchase the positions. When no buyers materialized, these firms were forced to liquidate, resulting in huge and dramatic losses. For example, Merrill Lynch's CDO assets were valued at $30.6 billion as of mid-June of 2008, yet were sold in July 2008 for $7 billion. This downturn should not have been so dramatic and a more transparent market place should have reflected a more moderate market decline over a longer period of time.

A Solution that Worked in the Past

The Volcker Rule has often been compared to the Glass-Steagall Act of 1933, which was enacted as a result of the stock market crash in 1929. And, many observers of the Glass-Steagall Act point out that the underwriting abuses that it purportedly targeted were not the real problem. The Securities Exchange Act of 1934 passed control of margin requirements to the Federal Reserve System in order to give them control over leverage. Thus, the commercial banks were separated from the investment banks, and the investment banks were subject to market discipline on how much risk and leverage they could take. This worked reasonably well for almost 70 years, and during that time the United States enjoyed global leadership in equity and debt markets.

The governing principles for the majority of those seven decades were as follows:

(1) Lending only on exchange traded instruments; and
(2) Immediately selling out those positions that exceeded explicit margin requirements.

In the final analysis, allowing a small group of systemically significant broker-dealers, especially bank-back ones, unlimited leverage and with essentially tax payer-backed, low-cost financing, ultimately created a systemic risk that almost brought the whole financial system down.

When the market finally reflected the declining values in the mortgage market the short-term borrowing disappeared, and the hedge funds moved their short positions with the cash collateral, which created a proverbial "run on the bank."

The underlying concept of margin requirements is to limit possible losses to the amount of resources pledged against the loan, and would help insure that the broker-dealer balance sheet, which includes customer credit balances, would not be put at risk.

It is important to recognize that the leverage created in the system by the six aforementioned broker-dealers was legal, and the participants were not some rogue operators, but rather were the leading financial institutions in the marketplace. As trading technology commoditized traditional broker-dealer agency activity and eroded brokerage fees, the major firms moved aggressively towards proprietary activities to maintain their financial scale.

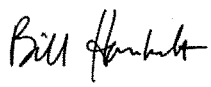
Summary

While broker-dealer balance sheets are remarkably opaque, it is now clear that the excessive leverage on the balance sheets of the too-big-to fail broker-dealers, now banks, were created by an absence of debt discipline and a dealer market that did not reflect true price discovery.

The bankruptcy of MF Global Holdings only reinforces the weakness of the capital adequacy rule, which allowed a broker-dealer to use its own balance sheet to support large trading positions. MF Global was leveraged by 34x its equity and used these funds to take a large position in European debt, yet was likely in compliance with the net capital rule. The "London Whale" incident at JPMorgan highlights how similar trading losses remain a problem in the core banking world as well.

The Volcker Rule, when it is finalized, should help restore some of the market discipline. It is important to remember that the law applies to both bank-affiliated firms and to systemically significant non-bank financial companies – thus ensuring that should any large stand-alone broker-dealers re-emerge, they will be covered too. However, to enhance The Volcker Rule's efficacy, the final version should also include limitations in leverage and additional capital charges to those activities that it permits, such as market making, along the line of what I have discussed today.

Respectfully submitted,



William R. Hambrecht
Chairman
WR Hambrecht + Co

Attached: Exhibit 1, Balance Sheets for Lehman Brothers and Bear, Stearns

WRHAMBRECHT+CO

Exhibit 1

Lehman Brothers and Bear, Stearns Balance Sheets

Lehman Brothers

Balance Sheet						
Balance Sheet as of:	Q2 May-31-2007	Q3 Aug-31-2007	Q4 Nov-30-2007	Q1 Feb-29-2008	Q2 May-31-2008	Prior Balance Q3 Aug-31-2008
Currency	USD	USD	USD	USD	USD	USD
ASSETS						
Cash And Equivalents	5,293.0	7,048.0	7,286.0	7,564.0	6,513.0	-
Cash & Securities Segregated	7,154.0	10,579.0	12,743.0	16,566.0	13,031.0	-
Securities Owned	218,112.0	-	-	268,070.0	226,378.0	-
Securities Purch. Under Agreem. To Resell	130,953.0	144,774.0	162,635.0	210,166.0	189,584.0	-
Securities Borrowed	119,119.0	142,553.0	138,599.0	158,515.0	124,842.0	-
Accounts Receivable	37,148.0	38,391.0	43,277.0	52,399.0	41,721.0	-
Gross Property, Plant & Equipment	5,716.0	5,999.0	6,299.0	6,756.0	6,975.0	-
Accumulated Depreciation	(2,197.0)	(2,322.0)	(2,438.0)	(2,567.0)	(2,697.0)	-
Net Property, Plant & Equipment	3,519.0	3,677.0	3,861.0	4,189.0	4,278.0	-
Goodwill	-	-	3,137.0	-	-	-
Other Intangibles	3,652.0	4,108.0	990.0	4,112.0	4,101.0	-
Invest. in Debt and Equity Securities	-	246,542.0	246,617.0	-	-	-
Trading Asset Securities	-	35,711.0	44,595.0	-	-	-
Other Current Assets	8,317.0	20,044.0	21,917.0	-	-	-
Deferred Tax Assets, LT	-	-	2,309.0	-	-	-
Other Long-Term Assets	73,585.0	5,689.0	3,097.0	64,451.0	48,884.0	-
Total Assets	806,861.0	659,216.0	691,063.0	786,035.0	639,432.0	-
LIABILITIES						
Accounts Payable	50,471.0	51,829.0	64,307.0	84,552.0	61,086.0	-
Accrued Exp.	15,172.0	17,157.0	16,039.0	11,596.0	9,802.0	-
Short-term Borrowings	205,067.0	269,394.0	269,295.0	292,528.0	222,233.0	-
Curr. Port. of LT Debt	17,144.0	13,997.0	16,801.0	18,510.0	20,991.0	-
Long-Term Debt	100,819.0	120,331.0	123,150.0	123,309.0	123,178.0	-
Trust Pref. Securities	-	-	-	4,978.0	5,004.0	-
Other Current Liabilities	158,015.0	140,840.0	149,617.0	196,903.0	141,507.0	-
Other Non-Current Liabilities	30,014.0	24,935.0	29,363.0	28,829.0	29,355.0	-
Total Liabilities	584,732.0	637,483.0	668,573.0	761,203.0	613,156.0	-
Pref. Stock, Redeemable	1,095.0	1,095.0	1,095.0	2,993.0	6,993.0	-
Total Pref. Equity	1,095.0	1,095.0	1,095.0	2,993.0	6,993.0	6,993.0
Common Stock	61.0	61.0	61.0	61.0	61.0	-
Additional Paid In Capital	9,610.0	9,602.0	9,733.0	11,129.0	11,268.0	-
Retained Earnings	18,133.0	18,915.0	19,698.0	19,880.0	16,901.0	-
Treasury Stock	(5,590.0)	(5,858.0)	(5,524.0)	(5,149.0)	(4,922.0)	-
Comprehensive Inc. and Other	(2,210.0)	(2,462.0)	(2,573.0)	(4,062.0)	(4,025.0)	-
Total Common Equity	20,034.0	20,038.0	21,395.0	21,839.0	19,283.0	19,283.0
Total Equity	21,129.0	21,133.0	22,490.0	24,832.0	26,276.0	26,276.0
Total Liabilities And Equity	806,861.0	659,216.0	691,063.0	786,035.0	639,432.0	-

WR HAMBRECHT+CO

Bear, Stearns

Balance Sheet

Balance Sheet as of:	Restated Q4 Nov-30-2006	Q1 Feb-28-2007	Q2 May-31-2007	Q3 Aug-31-2007	Q4 Nov-30-2007	Q1 Feb-29-2008
Currency	USD	USD	USD	USD	USD	USD
ASSETS						
Cash And Equivalents	4,595.0	5,891.3	11,178.3	18,142.6	21,406.0	20,796.0
Cash & Securities Segregated	8,804.0	8,125.9	4,652.5	13,459.6	12,890.0	14,910.0
Securities Owned	109,200.0	134,410.3	136,410.7	126,869.8	122,518.0	118,201.0
Securities Purch. Under Agreem. To Resell	38,838.0	37,248.0	42,271.7	32,144.2	27,678.0	26,868.0
Securities Borrowed	80,523.0	84,014.6	92,049.7	80,039.0	82,245.0	87,143.0
Accounts Receivable	35,601.0	39,837.3	45,828.4	42,264.5	52,737.0	52,844.0
Other Receivables	745.0	862.8	1,156.0	1,055.9	785.0	488.0
Gross Property, Plant & Equipment	1,632.0	1,700.3	1,807.0	1,889.8	1,754.0	1,804.0
Accumulated Depreciation	(1,152.0)	(1,192.1)	(1,059.9)	(1,104.1)	(1,149.0)	(1,196.0)
Net Property, Plant & Equipment	480.0	508.2	547.1	585.6	606.0	608.0
Invest. In Debt and Equity Securities	31,067.0	41,482.6	49,985.1	42,655.2	34,539.0	31,031.0
Deferred Tax Assets, LT	1,431.0	-	-	-	1,464.0	-
Other Long-Term Assets	39,149.0	41,100.8	39,224.0	39,874.5	38,295.0	46,096.0
Total Assets	350,433.0	394,511.9	423,303.7	387,091.0	395,362.0	398,995.0
LIABILITIES						
Accounts Payable	76,386.0	80,964.5	88,565.6	73,805.7	87,305.0	97,274.0
Accrued Exp.	4,018.0	2,076.0	2,956.8	3,060.8	2,952.0	1,213.0
Short-term Borrowings	122,128.0	143,080.3	152,955.6	148,084.4	143,804.0	135,972.0
Curr. Port. of LT Debt	-	-	-	1,362.0	9,586.0	7,166.0
Long-Term Debt	83,650.0	97,880.9	109,451.0	102,169.1	89,294.0	91,063.0
Trust Pref. Securities	-	262.5	262.5	262.5	263.0	263.0
Other Current Liabilities	30,392.0	32,144.3	33,533.7	33,398.8	30,315.0	35,034.0
Other Non-Current Liabilities	21,730.0	24,809.5	22,270.4	21,847.3	20,050.0	19,114.0
Total Liabilities	338,304.0	381,238.0	409,996.6	384,090.5	343,569.0	387,099.0
Pref. Stock, Redeemable	359.0	359.2	359.2	351.6	352.0	352.0
Pref. Stock, Other	-	-	-	-	-	-
Total Pref. Equity	359.0	359.2	359.2	351.6	352.0	352.0
Common Stock	185.0	184.8	184.8	184.8	185.0	185.0
Additional Paid In Capital	4,579.0	4,902.7	4,936.9	4,966.3	4,986.0	5,619.0
Retained Earnings	9,385.0	9,894.9	10,211.3	10,338.2	9,441.0	9,419.0
Treasury Stock	(4,445.0)	(4,610.6)	(4,888.2)	(5,339.4)	(5,641.0)	(2,913.0)
Comprehensive Inc. and Other	2,066.0	2,543.0	2,504.1	2,499.0	2,470.0	(796.0)
Total Common Equity	11,770.0	12,914.8	12,948.9	12,648.8	11,441.0	11,544.0
Minority Interest	-	-	-	-	-	-
Total Equity	12,129.0	13,273.9	13,308.1	13,000.5	11,793.0	11,896.0
Total Liabilities And Equity	350,433.0	394,511.9	423,303.7	387,091.0	395,362.0	398,995.0

Dennis M. Kelleher
President and CEO
Better Markets, Inc.
Testimony on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Part II"
The Committee on Financial Services
December 13, 2012

Good morning Mr. Chairman Bachus, Ranking Member Frank and members of the Committee. Thank you for the invitation to Better Markets to testify today.

Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight and accountability with the goal of a stronger, safer financial system that is less prone to crisis and failure, thereby, eliminating or minimizing the need for more taxpayer backed or funded bailouts. Better Markets has filed more than 110 comment letters in the U.S. rulemaking process related to implementing the financial reform law and has had dozens of meetings with regulators. Our website, www.bettermarkets.com , includes information on these and the many other activities of Better Markets.

My name is Dennis Kelleher and I am the President and CEO of Better Markets. Prior to that, I was a senior staffer in the Senate. Prior to the Senate, I was a litigation partner at Skadden, Arps, Slate, Meagher & Flom, where I specialized in securities and financial markets in the U.S. and Europe. Prior to obtaining degrees at Brandeis University and Harvard Law School, I enlisted in the U.S. Air Force while in high school and served four years active duty as a crash-rescue firefighter. I grew up in central Massachusetts.

INTRODUCTION

The Volcker Rule is, in many ways, very simple: it prohibits the handful of biggest too-big-to-fail banks from making high risk speculative bets, typically very, very big bets, usually but not always[1] with the banks' own money as distinguished from investing and trading their customers' money on their customers' behalf. This type of trading is nothing more than gambling. The reason for the rule is also simple: banks making such big speculative bets, usually with enormous amounts of borrowed money (i.e., the bets are highly leveraged), are very high risk and can pose a threat to the stability and solvency of

[1] JP Morgan's so-called "London Whale" loss arose from **a huge speculative proprietary trade using federally insured depositors' money**, which was done to generate profits for JP Morgan yet which generated more than $6 billion in gross losses for the bank so far. This is a stark example of why a ban on proprietary trading by systemically significant too big to fail banks is so essential to protecting investors, taxpayers, the financial system and, indeed, banks themselves. This is discussed in detail below.

not just the particular gigantic bank making the bet, but also that bank's counterparties, creditors, customers and, indeed, the financial system as a whole and, ultimately, the taxpayers who will be called on to bailout the bank when the bet loses.

Big banks gambling like this would be fine if it only threatened the betting bank and only the bank suffered the consequences. But that is not the case with proprietary trading by the biggest, taxpayer-backed, too-big-to-fail banks: they get the upside of their gambling and taxpayers get the downside when the bets go bad and the losses are lethal, as was evidenced in the recent financial crisis. It is only this type of very high risk speculative gambling by the biggest banks with their own or borrowed money for their own profit maximization that the Volcker Rule prohibits. Importantly, the rule expressly permits market making, risk mitigating hedging and other important legitimate types of banking activities.[2]

It is important to remember that the Volcker Rule is narrow in application and limited in scope: it only applies to the few banks that are so big that their failure would threaten the entire financial system and the country's economy – as they did in the financial crisis of 2008. Thus, it only applies to those banks that the federal government would spend any amount of money to prevent them from failing so that the country would not have to suffer a Second Great Depression, which almost happened as a consequence of the financial collapse of 2008.[3]

The Volcker Rule's prohibition is also narrowly targeted at a particularly pernicious, dangerous and, indeed, lethal type of big bank behavior: proprietary trading, where banks place huge bets with lots of borrowed money that promise enormous upside, but risk even greater downside. This type of conduct, a key reason for huge losses

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[2] Better Markets has filed four comment letters with various regulatory agencies in connection with the proposed Volcker Rule, which detail and elaborate on the topics discussed here. Links to those comment letters are below and they are incorporated as if fully set forth here: "Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds" (Nov. 5, 2010) *available at* http://www.bettermarkets.com/sites/default/files/FSOC-%20Comment%20Letter-%20Volcker%2011-5-10.pdf, "Prohibition on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds" (Feb. 13, 2012) *available at* http://www.bettermarkets.com/sites/default/files/SEC-%20CL-%20Volcker%20Rule-%202-13-12.pdf, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds (Apr. 16, 2012) *available at* http://www.bettermarkets.com/sites/default/files/CL%20CFTC%20FINAL%20Volcker%20Rule%204-16-12.pdf, and "Prohibition on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (June 19, 2012) *available at* http://www.bettermarkets.com/sites/default/files/SEC-%20CL-%20Supplemental%20Letter%20on%20Volcker%20Rule%206-19-12.pdf.

[3] Better Markets did a comprehensive review of the costs of the crisis and, using lost and avoided lost GDP, concluded that the cost of the crisis will be no less than $12.8 trillion. See BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012)("Cost of Crisis Report"), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_0.pdf.

in the 2008 financial crisis, is the equivalent of Russian roulette for any other firm or business in America where bad bets mean bankruptcy and, often, losing everything. The only place in American that doesn't happen is Wall Street: the biggest banks know that, if their bets lose and the roulette bullet hits them, they don't die or go bankrupt. Rather, the taxpayers will pick up the bill for their losses and prevent their failure, as demonstrated in the 2008 crisis.

And, that bill can be gigantic. Any unbiased analysis shows that the costs of the last financial crisis to the United States alone have been in the trillions of dollars, with many continuing to this day as the worst recession since the Great Depression ravages the country.[4] Depending on when it happens and what form it takes, the next financial crisis will likely cost at least as much, if not significantly more.

Those massive and debilitating costs are what financial reform generally and the Volcker Rule in particular are intended and designed to eliminate or reduce. The American people should never again have to pay trillions of dollars for another Wall Street bailout due to its reckless trading and investment activities.

Notwithstanding a relentless, comprehensive disinformation campaigns, implementing the Volcker Rule is not complex or difficult. The two keys are:

1. Focusing on compensation to break the link between proprietary trading and banker bonuses (via the bonus pool);
2. Backing up the law with swift, certain and significant penalties for traders, supervisors and executives; and

If the link between proprietary trading and banker bonuses is removed, then the incentive for proprietary trading will be gone. This can be readily accomplished by requiring that all compensation for the permitted activity of market making, for example, to be limited to the historic, well-known and free market, industry determined methods of fees and commissions.

This can then be easily policed after the fact by analyzing the bonus pool – after all, that is the entire purpose for proprietary trading: getting the biggest bonuses possible. Nothing is tracked more carefully on Wall Street than the bonus pool, which is a roadmap to where every penny was made or lost. Conveniently, this can be cross-referenced by the many individuals and desks that assiduously track this.

Because proprietary trading is banned and illegal, the firm cannot be allowed to profit from it either. A real market maker's trading book is fully hedged and, therefore, does not generate profits in excess of fees and commissions (other than in rare and extraordinary market conditions, when gains are as probable as losses, and either should be consistent industry wide). If such profits are somehow generated anyway, then

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[4] See Better Markets' Costs of the Crisis Report, cited above note 3.

increased prudential standards must be applied to bring the bank back into compliance with the law.

Some who attack the Volcker Rule say that is not possible to distinguish between proprietary trading and market making for customers. This is a very dubious claim given the oft heard claim that the smartest people on the planet work on Wall Street (and get paid unprecedentedly high compensation for being so smart). If they can't distinguish between proprietary trading for their own pocket and trading for their customers, then a very thorough investigation of their businesses is required and quickly. The logic of this argument against the Volcker Rule is that the banks today do not and cannot comply with the most basic investor protection rules regarding client funds as well as basic rules relating to risk, capital and legal compliance.

Importantly, limiting all trading compensation to fees and commissions will not be enough to end illegal proprietary trading. There is simply too much money at stake, especially bonus money, to expect people to follow the law unless there are very significant penalties for violating the law and a reasonable expectation that they will be caught. Those penalties have to be as significant as the potential gains if they are to be effective. If not, the cost of violating the law will become a cost of doing business and the illegal profits from proprietary trading will continue to flow, albeit diminished for the rare or occasional paltry fine. Even worse, the destabilizing risks that the Volcker Rule is intended to reduce or eliminate will remain, threatening our financial system, our taxpayers, our treasury and our economy. That is why very substantial penalties must be spelled out in the rule or it will be rewarding illegal conduct and inviting systemic risk.

The Volcker Rule is a reasonable response to a foreseeable and severe threat that materialized in the last crisis and contributed to systemic failure, which precipitated massive bailouts. Avoiding those trillions of dollars in costs (not to mention the equally high human costs arising from unemployment, foreclosure, etc.)[5] or, put another way, gaining the benefits of avoiding such a crisis, are why it is so important to implement the Volcker Rule as strong, effective and quick as possible.

Thus, for the reasons detailed below, the Volcker Rule is unlikely to reduce liquidity of U.S. capital markets, make it more expensive for businesses and consumers to borrow, depress the price of financial assets, impede the ability of U.S. financial institutions to compete against their foreign counterparts or dampen U.S. economic growth. To the contrary, removing the threat posed by these biggest too-big-to-fail banking giants to our financial system and economy is likely to unleash a renaissance in our financial industry as transparency, competition, and fairness create untold opportunities for current and new market participants. That will be good for our markets, financial system, economy, taxpayers and, indeed, the entire financial industry.

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[5] *See* Better Markets' Costs of the Crisis Report, n. 3 above.

The High Risk and Dangers of Proprietary Trading

There are many concrete examples of the dangers of speculative proprietary gambling by big systemically significant banks. While most examples relate to the too big to fail banks gambling their **own** or borrowed money, the most recent publicly disclosed example of a speculative prop trading going wildly wrong is JP Morgan's loss from trading by its Chief Investment Office (CIO) in London, the so-called "London Whale" trading debacle.[6] In this case, **JP Morgan gambled with federally insured depositors' money**, reportedly more than $100 billion of federally insured depositors' money.

JP Morgan's Multi-Billion Dollar London Whale Loss Due to High Risk Speculative Trading with Federally Insured Deposits

The recently reported trading by JP Morgan London whale would have violated the letter and not just the spirit of the law and proposed Volcker Rule if it were in effect. First, given the enormous net gains (reportedly 25% of the bank's net income for 2010) and losses (which now reportedly could be as high as $9 billion[7]) arising from this trading activity, it cannot properly be described as "hedging." And, given the swings in net profits and losses, it cannot properly be characterized as "**risk-mitigating** hedging," which is the definition of the permitted activity in the law and the rule.[8]

Moreover, it has been widely reported that JP Morgan's CEO personally transformed the CIO from a low-risk, highly liquid actual hedging operation into a high risk, speculative "profit seeking" operation; real "risk-mitigating hedging" does not generate net profits, which is what the CEO reportedly structured and staffed the CIO operations to create.[9]

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[6] *See* April 6, 2012, Wall Street Journal, page A1, "'London Whale' Rattles Debt Markets" and April 10, 2012, Bloomberg, homepage, "Making Waves Against the 'Whale.'" These articles provided specific details about the London CIO's high risk trading, how it was being done, who was doing it and that billions in losses were possible. On April 13, 2012, JP Morgan's CEO and CFO held an earnings call for the bank's first quarter results and emphatically dismissed these reports as inaccurate and provided comprehensive comfort to the public, regulators and investors. In fact, CEO Jamie Dimon said the reports were nothing but a "tempest in a teapot." Almost thirty days later, on May 10, 2012, Jamie Dimon disclosed, among other things, that the Wall Street Journal and Bloomberg reports from a month prior were in fact accurate.

[7] The actual gross losses thus far appear to be $6.2 billion, but JP Morgan disclosed that the losses could be as high as $9 billion. However, that is an incomplete picture of the losses created by this speculative high risk trading: JP Morgan's lost about $20 billion in market capitalization when this trading loss was first disclosed (and when the loss was said to be only about $2 to $3 billion). Added to that is more than 850 million shares of JP Morgan stock that was traded between the first press reports of the London Whale trades in early April 2010 and JP Morgan's first public admission that those reports were largely accurate about 30 days later. The net result is real, multi-billion losses for investors in addition to the actual losses from the trading.

[8] "(C) 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."

[9] "Dimon pushed [the CIO], which invests deposits the bank hasn't loaned, to seek profit by speculating on higher-yielding assets such as credit derivatives, according to five former executives. The CEO suggested positions, a current executive said. Profits surged over the next five years as assets quadrupled to $356

(While losses and profits may be generated, they should be largely offsetting, resulting in little net profit or loss, as discussed further below.) It was also reported that "the CIO... housed a lot of former traders from the bank's proprietary trading business, according to people who work there."[10] This personnel shuffle and hide-and-disguise "rebranding" of prop traders and trading was a key concern when the legislation was drafted and when the rule was proposed. Nonetheless, that is what is reported to have happened here and at the direction of the CEO.

In addition, the JP Morgan CIO's trading certainly involved "high-risk assets" and "high-risk trading strategies," which are also expressly prohibited by the law.[11] This is proved not only by the net profits and losses generated, but also by the fact that the CIO had to wager vast amounts of money to create those profits and losses, reportedly involving hundreds of billions of federally insured depositors' dollars. The CIO had, by the CEO's admissions, more than $350 billion under its control and much of that was apparently bet by the "London Whale" seeking to make a big splash and get a huge bonus, if not other rewards. Further proving the high-risk nature of these assets and trading strategies, they apparently involved relatively illiquid securities because the bank couldn't exit the investments in any reasonable period of time to minimize its losses. This too would violate the law and rule.

As if all that wasn't enough to demonstrate beyond a doubt that JP Morgan's trading would have violated the law and rule if they were in effect, it is also the case – as the CEO himself has admitted – that those very high risks were unknown to the bank; the bank's CEO, CFO, and other executives; as well as being unknown to the banks' risk, capital, legal and operational management.[12] The narrow permitted activity of "risk-mitigating hedging" cannot, by definition, occur by accident, which is why the proposed rule has detailed procedures to establish that such hedging is in fact risk mitigating and in fact bone fide (although, as set forth in Better Markets February 13, 2012 comment letter, those procedures need to be strengthened).

The fact that this particular example of high risk speculative proprietary gambling with federally insured depositors' money did not result in a loss to those depositors or require a federal bailout is irrelevant to the consideration of the Volcker Rule. First, it

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billion and employees were given proprietary-trading accounts, current and former executives said." Dimon Fortress Breached as Push from Hedging to Betting Blows Up, Bloomberg, May 14, 2012.

10 "How JPMorgan Shock Hit the War on Volcker," Financial Times, May 11, 2012

11 The Volcker Rule prohibits, among other things, any "transaction, class of transactions or activity ... if the transaction, class of transactions or activity ... would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies ...."

12 The accuracy of these claims is still being investigated and there are a number of reasons to conclude otherwise: "Staff from the bank's investment banking arm privately told management – including chief executive Jamie Dimon – that the bank's CIO was an 'accident waiting to happen.'" JP Morgan's $2bn loss was an 'accident waiting to happen,' The Telegraph, May 11, 2012; see also, "JP Morgan Pressed by SEC on Prop Trading Before Whale Loss," Bloomberg, December 11, 2012; JP Morgan's CEO Jamie Dimon: Incompetent or Culpable? http://bettermarkets.com/blogs/jp-morgan%E2%80%99s-ceo-jamie-dimon-incompetent-or-culpable#.UMiduYPAdyw ; Questions for Jamie Dimon's House Testimony, http://bettermarkets.com/blogs/questions-jamie-dimons-house-testimony#.UMitMYPAdyw

appears to be largely accidental that JP Morgan management even found out about this massive betting when it did: press reports brought it to their attention. Absent that, there's no reason to conclude that this trading loss would have multiplied many times over before it was discovered by management. That is what happened to the Barings Bank in 1995, which lost $1.3 billion and collapsed after 233 years, and the recent UBS $2 billion loss, among many others. Traders in big losing bets usually double down if presented with the opportunity.

Second, there is no reason to believe that the next prop trade gone bad will result in non-lethal losses either before or after doubling down. Third, letting after the fact losses influence before the fact policy making would be to turn law-making on its head. Fourth, as set forth below, there are plenty of examples of prop trading gone bad that were lethal or almost lethal but for federal rescues and bailouts.

Citigroup's Speculative Proprietary Trading Caused More Than $40 Billion in Losses

The damage inflicted on Citigroup by its broker dealer subsidiary vividly illustrates the threat that proprietary trading poses to even the largest banks. During the run-up to the crisis, Citigroup traders were among the largest creators and sellers of collateralized debt obligations ("CDOs"). The CDO business required traders to acquire a pool of assets, "structure" a new set of securities based on that pool, and then sell some or all of these newly structured securities to third parties. Creating and pricing the new securities required some expertise, but at its heart the CDO business was a convoluted proprietary trade in which the traders acquired assets, held them as inventory and planned to resell them later at a higher price.[13]

These CDO securities differed in their credit ratings, the rate of interest paid to investors and in their payment priority in the event of default. The quantity and characteristics of each class of security were chosen by the Citigroup traders to maximize their profits. They found it profitable to create a class of "Super Senior" securities which were nominally highly-rated and which paid relatively low interest rates. Citi traders found that investors were unwilling to buy the Super Seniors. But instead of offering the securities at a lower price and higher interest rate – which would have required lowering the rates paid on the other CDO securities and reduced their price – the Citigroup traders

[13] The securities comprising the CDO asset pools were varied – including RMBS, high grade bonds, and tranches from other CDOs. However, many of the underlying securities were constructed from subprime residential mortgages. The Office of the Controller of the Currency estimates that 70 percent of the assets underlying Citigroup CDO's issued between 2003 and early 2006 were subprime-related. *See* U.S. Office of the Comptroller of the Currency (2008). Memo from John Lyons, Examiner-in-Charge, Citibank, N.A., Subject: Subprime CDO Valuation and Oversight Review – Conclusion Memorandum, July 17, 5. *Available at* http://fcic.law.stanford.edu/resource/index/Search.Videos:0/Search.Documents:1/Search.endmonth:02/Search.endyear:2012/Search.Footnotes:10.42

continued to create Super Seniors and to hold them. They would only have created and held unsalable Super Senior securities to maximize their overall returns.[14]

To boost the return from holding the Super Senior positions, Citigroup relied on leverage. During 2003 and early 2006, Citigroup financed $25 billion in Super Senior securities through conduits. These special purpose vehicles ("SPVs") issued asset-backed commercial paper, for which Citi provided "liquidity guarantees." The guarantees meant that Citi would buy the commercial paper issued by the conduit if no one else would.[15] Liquidity guarantees meant that third party purchasers of the commercial paper faced default risk only if Citigroup itself failed to honor its guarantee, regardless of the market value of the Super Senior securities.

Citigroup ceased to issue liquidity guarantees in early 2006. However, between early 2006 and August 2007 another $18 billion in Super Senior securities were added directly to Citigroup's trading book positions. Because the securities were held in the trading account, little or no capital was required to back them.[16]

In late 2007 it became clear that the Super Senior securities were worth far less than their face value. To avoid having to make good on its liquidity guarantees, Citigroup bought $25 billion of commercial paper that had been issued by the Super Senior conduits, and placed those Super Senior securities on the books of the Citigroup commercial bank.

Beginning in November 2007, Citigroup was forced to recognize huge losses on the Super Senior securities and other positions.[17] In a remarkably understated 2007 annual inspection report on Citigroup, the Federal Reserve Bank of New York observed that "[m]anagement did not properly identify and assess its subprime risk in the CDO trading books, leading to significant losses. Serious deficiencies in risk management and controls were identified in the management of Super Senior CDO positions and other subprime-related traded credit products." [18] **By the end of 2008, Citigroup had written**

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[14] The Comptroller of the Currency recognized this motive for the Citigroup trading strategy in its January, 2008 review of Citigroup's CDO-related losses, noting that "The bank built up [Super Senior] positions because they are hard to sell in the primary issuance market at the nominal spreads available for [Super Senior] once deals were completed (10-20bps) and the bank was unwilling to give up some of the inception profits. " *See* Ibid.

[15] The amount of leverage on the Citi conduits is not clear from available data. If the SPVs were entirely financed by commercial paper, the leverage was infinite.

[16] Financial Crisis Inquiry Commission (2011). Final Report of the Financial Crisis Inquiry Commission, U.S. Government Printing Office, 196-197.

[17] Citigroup, Inc. (2007). Press release, November 4 (announcing losses of approximately $8 billion to $10 billion), *available at* http://www.sec.gov/Archives/edgar/data/831001/000110465907079495/a07-28417_1ex99d1.htm

[18] Federal Reserve Bank of New York (2008). Summary of Supervisory Activity and Findings for Citigroup, January1, 2007 – December 31, 2007, 5, *available at* http://fcic.law.stanford.edu/resource/index/Search.keywords:fcic-085390/Search.Videos:0/Search.Documents:1/Search.Interviews:0/Search.endmonth:02/Search.endyear:2012

off $38.8 billion related to these positions and to ABS and CDO securities it held in anticipation of constructing additional CDOs.[19]

These losses reduced Citigroup's capital, helped to bring the company to the brink of failure, and made a massive federal rescue necessary. Indeed, Citigroup was the largest single recipient of federal emergency assistance and required a total of $476.2 billion, including capital injections, debt guarantees, and asset guarantees, to prevent it from failing.[20]

Citigroup was also the heaviest user of the Term Securities Lending Facility ("TSLF"), and a very heavy user of the Primary Dealer Credit Facility ("PDCF"), two emergency lending facilities set up to halt a destabilizing collapse of broker dealers generally. Reliance on these facilities indicated that a broker dealer was having difficulty funding its positions in repo markets. So the fact that Citigroup went to the PDCF 279 times for overnight loans averaging $7.2 billion each, and used the TSLF to execute 43 swaps of "investment grade" collateral averaging $3.7 billion each, are clear signs that its broker dealer was in a very difficult shape. (See attached Appendix 1, below). The debacle at Citigroup is merely illustrative of the harm that bank proprietary trading produced and threatened to produce. The heaviest users of TSLF and PDCF funds includes several other bank-based broker dealers, among them Bank of America, Deutsche Bank, Credit Suisse and Barclays. (See attached Appendix 2, below). Although they did not create wreckage on the scale of Citigroup, they were clearly on the brink of doing so.

Other Too Big To Fail Banks High Risk Speculative Prop Bets Gone Wrong

JP Morgan and Citigroup were not alone in making gigantic, high risk, highly leveraged proprietary bets. Indeed, as was made visible during the crisis, trading assets made up a large proportion of total assets at all of the large stand-alone securities firms and all came under extraordinary pressure as the crisis spread. A major source of that pressure was losses and conjectured losses on their proprietary trading positions. For example:

- In June 2007, two Bears Stearns managed hedge funds – High-Grade Credit Fund and High-Grade Structured Credit Enhanced Leverage Fund – collapsed because of failed subprime mortgage trades. Bear was forced to rescue the funds by injecting more than $3 billion.[21] As a result market participants became increasingly concerned about Bear's solvency, and its repo lenders, on whom Bear was increasingly dependent, began to require more collateral

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19 *See* Citigroup, Inc., Form 10K for the period ending December 31, 2007, 48; Form 10K for the period ending December 31, 2008, 68.

20 *See* Special Inspector General for the Troubled Asset Relief Program (2011). Extraordinary Financial Assistance Provided to Citigroup, Inc., January 13.

21 http://www.nytimes.com/2007/06/23/business/23bond.html?pagewanted=all.

for loans. In March 2008, there was a run by Bear's repo lenders and over-the-counter derivative counterparties, and the firm failed.[22]

- In October 2007, Morgan Stanley recognized a $9 billion loss on proprietary trades related to subprime mortgages.[23] That loss forced the firm to obtain an equity injection of $9 billion from Mitsubishi UFJ to prevent failure and bankruptcy. Ultimately Morgan Stanley had to seek safety net protection by becoming a bank holding company to avoid failure.

- In mid-2008, Lehman Brothers began to publicly recognize significant losses. A major fraction of those losses came from proprietary positions Lehman had taken in subprime and Alt-A mortgages, in a belief that it would be able to securitize and sell them at a profit. Between the first quarter of 2007 and the third quarter of 2008 Lehman lost an estimated $7.4 billion on these proprietary positions.[24] In September, Lehman's repo lenders and over-the-counter derivatives counterparties concluded that the firm was no longer solvent, and the resulting run caused Lehman to fail.[25]

The Financial Crisis Inquiry Report summarizes role of proprietary trading at the stand-alone investment banks as follows:

> Lehman's collapse demonstrated weaknesses that also contributed to the failures or near failures of the other four large investment banks: inadequate regulatory oversight, risky trading activities (including securitization and over-the-counter (OTC) derivatives dealing), enormous leverage, and reliance on short-term funding. While investment banks tended to be initially more vulnerable, commercial banks suffered from many of the same weaknesses, including their involvement in the shadow banking system, and ultimately many suffered major losses, requiring government rescue.[26]

Banks Have Failed to Offer Empirical Evidence – To Which They Have Unique Access – To Support Their Claims about Market Making. When They Are Also Uniquely Incentivized to Do So if that Evidence in Fact Supports Their Claims

Banks have claimed that when they act as market makers they must hold substantial inventories of infrequently traded assets. Because these assets trade rarely, they say, continuous observable bid-ask spreads do not exist. In practice, they claim, market making in these assets is only possible because they can earn revenues from the

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22 National Commission on the Cause of the Financial and Economic Crisis in the United States, The Financial Crisis Inquiry Report (2011), New York: Public Affairs, 280-92.

23 http://www.nytimes.com/2007/12/20/business/20wall.html?pagewanted=all.

24 Report of Anton R. Valukas, Examiner, In re Lehman Brothers Holdings Inc., et al., (2010), 84-94.

25 National Commission on the Cause of the Financial and Economic Crisis in the United States, op. cit., 327-333.

26 *Ibid*, 343.

price changes on the positions they hold. Therefore, using the existence of a bid-ask spread or revenue from the bid-ask spread as indices of market making will drive them from their market making role.

For example, Morgan Stanley claims that because market makers must hold inventories of large or illiquid assets for "days, weeks or months," they must necessarily have "substantial revenues from market movements in their principal positions." [27] Citigroup Inc. says that in "all but the most liquid portions of the equity, rate and foreign exchange markets, profitability from bona fide market-making-related activity is significantly derived from price appreciation of inventory positions."

If Morgan Stanley or other banks really wanted to inform us about how market making works, they would have presented verifiable data to answer some basic questions about their business. For example, with respect to corporate bonds, for which bonds are they market markers? Which of these bonds are infrequently traded, and which are frequently traded in the market as a whole? For which of these bonds do they typically hold inventories, and for which of them do they meet client demand by acting as agents or brokers? For those bonds in which they maintain positions, how large are their inventories? For which of the bonds in their inventory is there an observable bid-ask? How much of their trading revenue comes from frequently traded bonds for which there is an observable bid-ask? These and other relevant data are not forthcoming from the banks.

When data are offered, they are often beside the point. Morgan Stanley, for example, in an appendix to its February 13, 2012 comment letter on the proposed rule, provides descriptive statistics on the frequency of bond trades during 2009. However, these data are derived from TRACE, a publicly available source. Such data tell us nothing about the actual market making activity of Morgan Stanley or any other large bond trader.

These data provide **no** evidence that Morgan Stanley actually holds inventories of any of the infrequently traded bonds identified in the appendix, nor do they tell us anything about the availability of bids and asks for frequently traded bonds. The failure of the banks to provide meaningful data in their exclusive possession, and their focus on data that are irrelevant to the issues being discussed, leaves regulators with **no** data supporting their assertions.

Given that they are self-interested market participants with the unique ability to support their claims with data, but chose not to, there is no defensible conclusion other than such data does not exist or, more likely, is not supportive. After all, if their claims

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[27] Comment Letter on the Notice of Proposed Rulemaking Implementing the Volcker Rule – Proprietary Trading, from C. Kelleher, Co-President, Institutional Securities Group, and J. Rosenthal, Chief Operating Officer, Morgan Stanley. February 13, 2012, 4 ("Morgan Stanley Comment Letter"); Comment Letter on the Joint Notice of Proposed Rulemaking Implementing the Volcker Rule, from Brian Leach, Chief Risk Office, Citigroup. February 13, 2012, 4 ("Citigroup Comment Letter").

were correct, it obviously would be in their interest to support their case empirically. They chose not to. Legislators, regulators and policymakers have no choice but to disregard such unsupported assertions and claims under such circumstances.

Independent Evidence Contradicts Bank Claims about Market Making for Corporate Bonds

Claims made about the market for U.S. corporate bonds – a market which banks have cited in their arguments that large scale asset inventories and revenue from price appreciation are essential to market making [28] – are contradicted by independent academic research.

A recent scholarly article, for example, suggests that dealers hold only small inventories of bonds that are frequently traded and no inventories of bonds that trade infrequently:

> "One argument against proposals to increase transparency in a dealer market is that dealers will become reluctant to enter trades as principals – that is, by themselves, purchasing bonds from customers or selling customers bonds owned by the dealer – and instead will only be willing to work orders on an "agency basis" – that is, they will search for potential counter parties (Genmill, 1996). In interviews, numerous corporate bond market participants voiced similar concerns. **We were told that, post-TRACE, bond dealers no longer hold large inventories of bonds for some of the most active issues; for less active bonds, they now serve only as brokers.** As noted, individual corporate bond issues trade on average only two or three times per day, and for illiquid issues even less often. With trade reporting, it may be possible to ascertain when a dealer may have taken a large position into inventory, and the price paid. Knowledge of the dealer's inventory may allow market participants to forecast upcoming trades the dealer will undertake to rebalance inventories, and these forecasts may in turn cause price movements adverse to the dealer." [29] [emphasis added]

A second empirical study, using data from a sample of traded corporate bonds, also indicates that dealers avoid holding inventories of infrequently traded bonds.[30]

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[28] Comment Letter on Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds, from J. F. W. Rodgers, Chief of Staff, Goldman Sachs Group, Inc., February 13, 2012, 12; Morgan Stanley Comment Letter, op. cit.,4, appended Discussion Materials; Citigroup Comment Letter, op. cit.

[29] H. Bessembinder and W. Maxwell (2008). Transparency and the Corporate Bond Market. Journal of Economic Perspectives, Volume 22, Number 2, 217-234, 228.

[30] M. Goldstein et al. (2007). Transparency and Liquidity: A Controlled Experiment on Corporate Bonds. The Review of Financial Studies. Volume 20, Number 2, 235-273. In the sample used in this study

Sample data show that when infrequently traded bonds are added to dealer inventory, they are held for shorter periods than frequently traded bonds, and the entire position is more frequently sold off to buyers. The authors conclude that for infrequently traded bonds "... **dealers may serve more of a search role, matching buyers and sellers, and not assuming the risk of holding bonds in their inventory.**" [emphasis added] [31]

It is important to emphasize that even after TRACE was introduced, post-trade bond prices became widely available, and bond traders reduced their inventories of infrequently traded bonds, the market for corporate bonds did not vanish. Between 2002, when TRACE was introduced, and 2006, the average daily trading volume for corporate debt increased from $18.9 billion to $22.7 billion.[32] Market makers continued to flourish, although their ability to extract rents from their counterparties was reduced.[33]

There are other recent examples, not directly related to market making, that illustrate how profit opportunities prompt rapid entry and adaptation in financial markets. When regulation NMS reduced regulatory barriers to entry for electronic market centers, there was rapid entry of new trading platforms and an increase in competition. As a recent academic study notes:

> Regulation NMS freed electronic trading platforms to compete with the NYSE. Subsequently, new entrants gained significant market share. The NYSE market share of volume in its listed stocks fell from 80% at the beginning of 2003 to 25% by the end of 2009. NASDAQ matched share volume also increased, but later fell as volume traded through new entrants such as BATS and DirectEdge increased.[34]

Entry of new trading firms has been facilitated by technological and conceptual developments that have fostered the creation of high frequency trading ("HFT"). One of the distinguishing features of HFT is that is can be executed with relatively small amounts of capital. Positions are held for very short time periods, and the books of HFT firms are typically flat at the end of the day.[35] Because this overcomes the cost advantage of the

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frequently traded bonds are defined as those that trade at least once per week. Infrequently traded bonds trade less than once every two days, but at least once every two weeks.

31 *Ibid*, 267.

32 Bessembinder, op. cit., 222.

33 After the implementation of TRACE, transactions costs for corporate bond trades declined. *See* Bessemer and Maxwell, op. cit.; Goldstein et al., op. cit.; A. Edwards et al. (2007). Corporate Bond Market Transparency and Transactions Costs. Journal of Finance, Volume 19, Number 1, 69-90.

34 J. Angel et al. (2010). Equity Trading in the 21st Century, USC Marshall Research Paper FBE 09-10, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1584026.

35 Technical Committee of the International Organization of Securities Commissions (2011). Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency, Consultation Report CR0211, July, 21, *available at* www.iosco.org/library/pubdocs/pdf/IOSCOPD354.pdf.

established dealers, including those located in the LBHCs, numerous HFT firms have entered an activity in which bank dealers once played a more prominent role.[36]

Another classic example of competitive entry in response to newly created profit opportunities is the events following the passage of the Glass-Steagall Banking Act, passed in 1933 during the Great Depression. The Banking Act required commercial banks to exit from investment banking (including underwriting and trading) one year after enactment. Commercial banks divested their investment banking operations, thereby creating profit opportunities for new entrants. New investment banks were quickly formed, often employing the experienced personnel formerly located in the commercial banks.

As Vincent Carosso notes in his historical study of investment banking:

> A major reorganization of the investment banking industry immediately resulted from the Banking Act. Affiliations were eliminated; the bond departments of commercial banks were cut in size and their activities greatly reduced; and private bankers were forced to choose between deposit and investment banking....
>
> Implementation of the Banking Act also led to the organization of new investment firms. Most of these were officered and staffed by the individuals formerly associated either with security affiliates or with private banks that had decided to give up the security business. The First Boston Corporation, one of the largest and leading underwriting

[36] This example is an illustration of market entry when a profit opportunity presents itself. We do not here make a judgment regarding whether this particular entry, HFT, was good or bad for the markets, in whole or in part. See, e.g., S. Arnuk, and J. Saluzzi (2012). Broken Markets, Pearson Education LTD: FT Press. *See also,* Comment Letters of Better Markets: "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest" (November 15, 2010), 9,18, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26475&SearchText=, "Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act" (January 3, 2011), 2, 4, 7, 9-14, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26928&SearchText=, "Reporting, Recordkeeping and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants" (February 7, 2011), 1-2, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27630&SearchText=, "Core Principles and other Requirements for Designated Contract Markets" (February 22, 2011), 3-10, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27994&SearchText=, "Core Principles and Other Requirement for Swap Execution Facilities" (March 8, 2011), 12-18, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31238&SearchText= , "Antidisruptive Practices" (May 17, 2011), 2-3, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42710&SearchText= , "Reopening and Extension of Comment periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act" (June 3, 2011), 7-8, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=44711&SearchText=, "Clearing Member Risk Management" (September 30, 2011), 5, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48477&SearchText=.

> and bond-trading houses since its establishment, is a case in point. Organized on June 16, 1934, as a publicly owned corporation, it was a rare phenomenon among investment banking firms. The First Boston grew out of the securities affiliate of the First National Bank of Boston, with some key personnel also coming from the old Harris, Forbes organization...
>
> In September 1934 three Morgan partners and two from Drexel resigned and organized Morgan Stanley & Co., Inc., an investment banking corporation. **They moved just at the time the securities business was starting to revive...**
>
> Numerous other similar changes occurred in 1934 and 1935, as former officials and associates of security affiliates and partners in private banking houses organized new firms or joined existing ones....[37]

Despite these rapid changes required by the change in regulation, which allowed just one year for total divestiture, the newly configured investment banking industry was able to handle a large increase in underwriting volume that occurred in 1935.[38]

Precisely these types of entry and market adaptions have been happening routinely since the passage of the financial reform law. For example, the Financial Times reported recently that "the former head of proprietary trading at Citigroup," who is also the "former head of proprietary trading at Morgan Stanley," is launching "one of the largest hedge fund start-ups of 2012."[39] This is similar to what has already happened when proprietary traders left JP Morgan Chase and Goldman Sachs, which "has spawned the largest number of hedge fund start-ups in recent years."[40]

Given these examples, there is little reason to believe that there will be a shortage of market making services, even if the Volcker Rule caused the large bank holding company dealers to cease providing them completely. That outcome, however, is unlikely given that the law specifically permits genuine "market making ... designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." Any bank, including the largest banks, can engage in unlimited market making if, for example, it ran a flat book or a truly hedged book, with gains offsetting losses thus eliminating proprietary positions in connection with market making.

Thus, the market can be expected to adapt and the largest banks will provide many of the same services they do now, but in compliance with the law and at much

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[37] V. Carosso (1970). Investment Banking in America: A History. Cambridge: Harvard University Press, 372-374. (emphasis added)

[38] R. Chernow (1990). The House of Morgan. New York: Atlantic Monthly Press, 390.

[39] "Sharma to launch $500m London Hedge Fund," *available at* http://www.ft.com/intl/cms/s/0/94e28e48-b870-11e1-82c8-00144feabdc0.html#axzz1y6Ui5ash.

[40] *Id.*

lower risk of failure and taxpayer bailouts, and new market entrants will provide the services that the largest banks choose not to provide.

So contrary to the claims made by banks, the operation of the corporate bond market actually demonstrates that market making does not require that dealers hold significant inventories of infrequently traded assets. Effective implementation of the Volcker Rule, which requires tying permitted trading revenue and compensation to observable bid-ask spreads, will not bring an end to genuine market making by banks. Instead it will limit the ability of banks to take proprietary positions in pursuit of large speculative profits. While banks may object, the banking system will become more stable as a result, which is the ultimate objective of the Volcker Rule.

The Industry's Study is Expressly and Admittedly Incomplete and Should be Disregarded Entirely

The industry has produced and relies on a paper by the consulting firm of Oliver Wyman. Given that the paper was purchased by one of the industry's top lobby and trade associations SIFMA on behalf of the industry, it is no surprise that it agrees with SIFMA's and the industry's position on the Volcker Rule. Like their other arguments, however, the paper is deeply flawed. Better Markets addressed these flaws in its comment letters (specifically in the April 16, 2012 and June 19, 2012 comment letters), but I will briefly address the primary flaw here: Oliver Wyman, without explanations or basis (and contrary to basic economics, facts and history), assumed that there would be no new entrants into the business of market making if the few biggest too big to fail banks stopped making markets as a result of the Volcker Rule (which itself is a highly dubious assumption because market making is an expressly permitted activity and would only require hedging if they wanted to do it or, as the data above suggests, get back to doing it).

Specifically, the Oliver Wyman paper stated that "[w]e do not directly analyze a wide range of potential knock-on effects, including... [t]he potential replacement of some proportion of intermediation currently provided by Volcker-affected dealers by dealers not so affected." As set forth in our comments letters of February 13, 2012, April 16, 2012 and June 19, 2012, there is, however, a great deal of historical and contemporary evidence that entry is the normal market response to profit opportunities like this, including recently in the corporate bond markets.

This should come as no surprise to anyone. After all, the big dealer banks are not nonprofit organizations and do not make markets for free. They do it to make money and because there is money to be made. If they don't make that money, other market participants will move into the business to reap the profits. There is simply no basis to conclude otherwise. Self-serving industry claims contradicted by independent facts, research and history should be disregarded.

Swift, Certain and Substantial Penalties Must be Publicly Imposed on Traders and Management Alike for Any Violations of the Volcker Rule Under a Strict Liability Standard.

The regulatory system for the Volcker Rule **cannot** be constructed to require regulators to find a needle in a haystack when the "needle hiders" are extremely sophisticated, highly motivated and richly rewarded. Of course, they also have vastly more resources and much greater ability to hide and disguise their conduct than the regulatory agencies.

The most senior operating, financial and compliance management at financial institutions must be responsible for full compliance with the Volcker Rule and they must be held accountable for such compliance. It has to be their job to ensure that potential "needle hiders" are supervised, monitored, caught and punished and, if they fail at their job, then management must be punished as well.

This is what the statute contemplates in the "Anti-Evasion" provisions in Section 13(e): the appropriate regulators "shall" issue regulations "regarding internal controls and recordkeeping, in order to insure compliance with this section," i.e., prohibition on proprietary trading. Because senior management is always the first line of defense, these regulations must require that the appropriate officers be directly involved in compliance and be held accountable. Among other things, one or more of these officers should be required to certify periodically that the banking entity has fully complied with the law or that it has promptly disclosed to the appropriate regulators each transaction or set of transactions which violated the law.

Self-policing, self-correction and self-reporting have to be the cornerstone of any effective compliance regime, but that will only work if the most senior management is involved and explicitly accountable.

Also, as contemplated by the statute, strict liability should be the standard imposed for violations of the Volcker Rule. The reason is obvious: anything less will inevitably result in unending disputes, encourage game playing and defeat deterrence.

Indeed, not only does the statute contemplate strict liability, it also requires regulators to order the termination of the activity and/or disposition of the investment. For example, Section 13(e)(2) provides for the "Termination of Activities or Investments" on a strict liability basis: "whenever [a regulator] has a reasonable cause to believe that a banking entity or nonbank financial company supervised by the Board ... has made an investment or engaged in an activity in a manner that functions as an evasion of the requirements of this section (including through an abuse of any permitted activity) or otherwise violates the restrictions under this section... **shall order**...[the] terminat[ion of] the activity and, as relevant, dispose of the investment." (Emphasis added)

This explicitly mandated action is in addition to all the other authority the appropriate regulatory agencies have to penalize violations of law. Thus, termination

and/or disposition of the violating trade are **the statutorily minimum** action regulators **must** take.

However, such a sanction by itself would be grossly insufficient to obtain compliance with the law. Indeed, it might actually encourage violations because termination or disposition of the investment merely forfeits the upside, but has **no meaningful downside.**

As is painfully obvious, financial institutions are populated with risk-takers and only by concretely affecting their risk/benefit calculations **before** any violation occurs will there be any hope of compliance with the Volcker Rule.

The Volcker Rule should include a sliding scale of very strong penalties to ensure that violating the Volcker Rule does not simply become a cost of doing business. There must be substantial fines and penalties for any violation of the rule and such penalties must be imposed swiftly. For example, if a regulator has reasonable cause to believe the rule has been violated then it must be empowered to impose immediately an administrative penalty of (1) 10 times the gross profit or loss from the trade, (2) a six month bar on the trader responsible for the trade, and (3) a cease and desist order to the firm. If there is a second violation, then the penalties should double, a preliminary injunction should issue against the firm, and the responsible member of management should be barred for six months from being affiliated with any financial institution.

To ensure compliance and obtain deterrence, while incentivizing a robust comprehensive internal compliance system supported by aggressive management oversight, a financial institution could avoid the penalties only if it detects, corrects and reports the violation to regulators promptly. The institution must also sanction all employees involved in the violation and those sanctions must be publicly reported.

Without very significant sanctions and public reporting, there will be no deterrence and, without deterrence, there will be little compliance with the Volcker rule.

Follow the Money: Bonus Pools and Other Already Collected, Readily Available Data Provide a Roadmap for How the Money is Made and Where the Risks Are.

Financial institutions and their personnel already collect and precisely track, aggregate, analyze and disseminate every meaningful piece of information related to their business, including all trading, throughout the day and at the end of every day, week, month and quarter. Conveniently, it is all electronically gathered, sorted, stored and can be readily transmitted to any appropriate recipient.

Just one example, in an interview with Bloomberg Business Week published in April 2010, Goldman Sachs' CFO said "I personally see the profit and loss statement of each of our 44 business units every single night." You can be sure that the finance officers below him do as well (and they also review every piece of information that gets rolled up into the P&L for their respective business units) because the CFO might call with a

question. And, you can be sure that the CFO's superiors are also routinely reviewing financial information.

This data gathering is particularly true for any activity where the firm's own capital is at risk or might be at risk, which is the case with any proprietary trading. Financial institutions have robust and specific approval and monitoring procedures whenever the firm's capital is put at risk. Importantly, all those processes have comprehensive record keeping requirements at the trade, desk and/or deal level, the business unit level, the finance department level, the management monitoring level and in compliance as well.

Because regulators will be requesting information specific to an institution's businesses and activities, such information should be readily available as a routine matter. Therefore, any institution claiming **not** to have such requested data should be required to report that fact in writing to that institution's Board of Directors, Audit Committee, accountants and lawyers.[41]

Importantly, however, the regulators should not limit themselves to the traditional data gathered and reviewed. For example, one of the most important, and the most illuminating, data collections at every financial institution is the bonus pool as it is assembled month-by-month to quarter-by-quarter to annual finalization and distribution.

Few items receive more or closer attention than the components of the bonus pool. It simply cannot be overstated the amount of time, effort and energy that is directed to assembling, analyzing, designating (prior to year-end) and allocating (at year end) the amounts and recipients of monies in the bonus pool. And, all of this information is gathered and tracked scrupulously by, among others, each person who will be fighting for the largest bonus possible based on their claimed contribution to the firm's profits (and/or other bonus components).

Reverse engineering the bonus pool (as well as the P&L) will show regulators precisely where the money is being made (and lost), by whom and as a result of what activity. This is an invaluable roadmap. The famous saying is as true today as it was decades ago (albeit in a very different context): follow the money and it will lead you to most of the answers you need.

Ending high risk speculative proprietary trading requires eliminating the unimaginably large compensation and bonuses that flow from it and that means aggressively monitoring the bonus pool.

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[41] It is important to remember that the gathering and review of this data in a robust and nimble electronic system is already required by numerous rules, regulations and statutes as well as by compliance and outside auditors (not to mention the Audit Committee). In particular, the outside auditors must annually determine whether the company has an effective and comprehensive system of internal controls.

Testimony of Jeffrey Plunkett
On behalf of the
Association of Institutional INVESTORS
Before the House Committee on Financial Services
December 13, 2012

Chairman Bachus, Ranking Member Frank, Members of the Committee, thank you for inviting me to testify today on behalf of the Association of Institutional INVESTORS (the "Association") regarding the Association's suggested changes to Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which is commonly referred to as the Volcker Rule.

My name is Jeffrey Plunkett, and I am the General Counsel and Executive Vice President for Natixis Global Asset Management, a founding member of the Association. The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment managers in the United States. Our members manage money on behalf of institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and the concerns we raise are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

The Association's Concerns with the Volcker Rule

When the Volcker Rule was originally enacted, it was aimed at limiting high-risk proprietary trading strategies at a handful of very large banks. Since passage of the Dodd-Frank Act, Congress has urged regulators to draw clear lines limiting activities that are clearly proprietary trading, while still allowing banks to engage in permitted banking and market making activities. The regulators, however, have not found this objective easy to meet with the current statutory language, struggling to reach consensus nearly half a year after the deadline for implementation.

We believe that congressional clarification in the form of a technical amendment bill would significantly help the regulators in their implementation efforts.

Despite Congressional intent[1] that the Volcker Rule only affect the proprietary trading activities of large banks while continuing to allow banks to make markets, the proposed rule[2] issued by the regulators in October 2011 would have far-reaching consequences for investors. Asset managers and their clients rely on banks to execute trades. Anecdotal evidence suggests that in today's market well more than half of institutional investment adviser transactions consist of trades with banks, including foreign banks. In this role, banks are providing critical services for the functioning of the secondary market.

The regulators' proposed rule may force bank dealers to stop facilitating transactions for customers because of compliance costs and uncertainty regarding the boundaries of permissible and impermissible activities. This is due, in part, to the rule's complex, after-the-fact tests for determining whether a bank is engaging in proprietary trading, which do not reflect the realities of financial markets. We believe the regulators are simply doing their best to implement the statute as written. However, unless changes are made to the proposed rule, there will be significant disruptions to both liquid and illiquid sectors of the market.

Additionally, the Association understands the need to limit banking entities' relationships with hedge funds and private equity funds. The regulators' interpretation of the statute, however, is over-inclusive, and significantly and unnecessarily harms asset managers that are affiliated with banking institutions. Many of the covered fund restrictions could be drafted in a manner that effectively addresses systemic risk to the financial system without creating a competitive disadvantage for asset managers that are affiliated with banking institutions.

Mr. Chairman, we support your efforts to formulate a less burdensome Volcker Rule and we appreciate your request for industry input on suggested alternatives to the Volcker Rule. While we understand the underlying policy considerations for incorporating the Volcker Rule in the Dodd-Frank Act, we welcome opportunities to work with Congress and with the financial regulators to ensure that the ultimate restriction still permits markets to function efficiently and fairly.

The Association submitted a comment letter on September 7, 2012, in response to the Chairman's request for industry comments, which discusses our specific concerns and offers suggested changes that would address each concern. The letter also offers legislative text that would implement each of the Association's suggestions. We would like to incorporate this letter and its recommendations by reference into the record and have attached this letter as Appendix

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[1] *See e.g.* 156 CONG. REC. S5906 (daily ed. July 15, 2010) (statement of Sen. Bayh (D-IN)): "With respect to the Volcker Rule, the conference report states that banking entities are not prohibited from purchasing and disposing of securities and other instruments in connection with underwriting or market making activities, provided that activity does not exceed the reasonably expected near term demands of clients, customers, or counterparties. I want to clarify this language would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function. Without that flexibility, market makers would not be able to provide liquidity to markets."

[2] 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).

A. Additionally, many of the Association's concerns are further discussed in the Association's February 13, 2012 comment letter submitted to the regulators in response to their proposed rule. This letter is also incorporated by reference and attached as Appendix B.

Conclusion

Mr. Chairman, as you and the Committee begin to consider draft legislation to amend the Volcker Rule, we hope our suggestions serve as a foundation for your efforts. Each of our suggestions is intended to mitigate unintended, adverse consequences that will ultimately affect the millions of American investors who rely on the continued vitality of their pension plans and 401(k) accounts. We thank you and the Committee for considering our letter and for giving industry concerns with the Volcker Rule the serious attention they deserve. As the Committee progresses toward making technical corrections to Section 619, we stand ready to provide useful guidance as a non-conflicted voice for investors.

Thank you for the invitation to participate in today's hearing.

APPENDIX A

Comments of the Association of Institutional INVESTORS
In Response to Chairman Bachus' Public Request for Input on Volcker Rule Alternatives
September 7, 2012

September 7, 2012

The Honorable Spencer Bachus, Chairman
House Financial Services Committee
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Public Request for Input on Volcker Rule Alternatives

Dear Chairman Bachus:

The Association of Institutional INVESTORS[1] (the Association) appreciates the opportunity to provide the House Financial Services Committee (HFSC) with specific legislative text and explanatory text that would amend certain provisions of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).[2]

The Association supports HFSC's efforts to formulate a less burdensome alternative to the Volcker Rule and appreciates HFSC's request for additional comments from those that would be directly affected by the rule. We believe the text of Section 619, and by extension the regulators' proposed rule (Proposed Rule),[3] will have resounding effects on the future of our industry, because it will

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[1] The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

[2] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

[3] 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).

determine whether banks will continue to serve as liquidity providers and counterparties to trades on behalf of our clients. Therefore, we welcome the opportunity to work with HFSC as it considers how best to make this provision workable, striking a balance between limiting risky behavior at banks and ensuring that banks can continue to serve the needs of our clients.

OVERVIEW OF THE ASSOCIATION'S SUGGESTIONS

The Association represents asset managers that work on behalf of institutional investors, such as pension funds and 401(k) accounts. Although Section 619 of the Dodd-Frank Act, and by extension the Proposed Rule, is focused on the activities of banks, we believe that an inappropriately expansive Volcker Rule will have far reaching consequences for millions of American investors who rely on the continued vitality of these pension plans and 401(k) accounts.

Specifically, financial regulators have interpreted the language of Section 619 and drafted a Proposed Rule that reduces in the breadth of investment options available to American investors. The Proposed Rule could force bank dealers to stop facilitating transactions for customers in situations where the compliance costs and uncertainty about the boundaries of permissible and impermissible activities are too great, even though the banks are not engaging in "proprietary trading." Going forward, we also believe there will be diminished depth of both liquid and illiquid sectors of the market due to the complex nature and interplay of the factors and metrics that seem impracticable to implement. The Proposed Rule also has been subject to significant international criticism, as international bodies such as the G-20 have worked toward international coordination of financial regulatory reform. The Association believes that changes to the statute should be considered to foster international consensus regarding the provision.

To address these harmful and unintended consequences, specific technical amendments must be made to Section 619 of the Dodd-Frank Act. By doing so, we believe it is possible to achieve the goal of limiting risky proprietary trading, while allowing banks to continue legitimate activity on behalf of institutional investors. The following sections of this memorandum discuss specific issues that we believe must be addressed within Section 619, including providing HFSC with a "blackline" of suggested legislative amendments. Appendix A to the document then provides a copy of the Association's suggested legislation to amend Section 619 and implement each of these changes.

SPECIFIC LEGISLATIVE RECOMMENDATIONS WITH EXPLANATORY TEXT

a. Proprietary Trading Restrictions

i. Presumption of Proprietary Trading

Although the Association does not believe it was the intent of Congress, under the Agencies' Proposed Rule, banks must meet a set of criteria to show that they are not engaged in proprietary trading. This creates the presumption that the activity *is* proprietary trading unless the banks prove otherwise. The Association believes this may result in banks being unwilling to take principal risk to provide liquidity services to institutional investors, because Agencies have the ability to second-guess

a bank's actions after it has completed trades, making it difficult or risky for the bank to assist asset managers in executing such trades.

Although we recognize the desire to inhibit efforts to evade the prohibition that could result if the definition were to be drawn too narrowly, we believe these concerns are overshadowed by what may result from an overly broad or unclear definition. Further, given the anti-evasion provisions and significant oversight and reporting requirements, it is unnecessary to draft an over-inclusive definition for fear of attempts to evade the prohibition.

Suggested Change: Congress should clarify that the Agencies should focus on trading activities that "are conducted solely for the purpose of executing trading strategies that are expected to produce short-term profits without any connection to customer facilitation or intermediation," as described by Federal Reserve Governor Daniel Tarullo. This would limit proprietary trading to situations that are "not difficult to identify" and would be consistent with former Federal Reserve Chairman Paul Volcker's statements that it should be easy to recognize proprietary trading.

Legislative Text:
"(h) DEFINITIONS.—In this section, the following definitions shall apply:
"(4) PROPRIETARY TRADING —The term 'proprietary trading', when used with respect to a banking entity or nonbank financial company supervised by the Board, means, subject to the following sentence, engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine. For purposes of this definition, the term 'proprietary trading' is limited to principal transactions effected for the purpose of executing trading strategies that are expected to produce short-term profits without a clear connection to customer facilitation or intermediation.

A. Market Making Exemption

In particular, the market making test under Section 619 (d)(1)(B) is ambiguous and may lead to uncertainty as to whether the Agencies will interpret legitimate behavior as proprietary trading, and thus may make it difficult for banks to engage in market making activity. If banks are unwilling to continue intermediating trades for institutional investors because the Proposed Rule creates uncertainty as to whether such activity is market making, the ultimate harm will fall on individuals and families, who utilize pension funds and 401(k) funds for their retirement savings.

Suggested Change: The Association urges Congress to clarify that market making activities taken on behalf of customers fall within the market making exemption. The meaning of the phrase "reasonably expected near term demands of clients, customers, or counterparties" in Section 619(d)(1)(B) should also be clarified to state that "near term" does not limit the market making trading activity in markets that are illiquid or have episodic liquidity.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:
"(B) The purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) in connection with underwriting or market-making related activities reasonably related to customer facilitation or intermediation, to the extent that any such activities permitted by this subparagraph are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. For purposes of this section, the term "reasonably expected near term demands" shall be based on the specific liquidity characteristics of individual markets and products.

B. Risk Mitigating Hedging Exemption

The Agencies' Proposed Rule also provides a number of requirements that firms must attain in order to rely on a risk-mitigating hedging exemption. According to the Proposed Rule, the criteria is intended to define the scope of permitted risk-mitigating hedging activities and to prohibit reliance on the exemption for proprietary trading that is mischaracterized as permitted hedging activity.

The Association agrees that hedging is an appropriate indicator of an entity's risk appetite, but believes that this indicator breaks down at the trade-by-trade level. In particular, this indication fails when gauging whether hedging activities are proper for illiquid markets, where perfect hedges are often not available. Further, members of the Association trade with market makers that use generally available hedges to bridge the gap between time and price with various traders in the market. The hedging exemption, therefore, must include a broad definition of what constitutes a "trading unit" (also known as an "aggregation unit") to permit banking entities to hedge adequately their trades with institutional clients.

Suggested Change: Congress should clarify that the Agencies must allow coordinated aggregate risk-mitigating hedging activities that are implemented across trading units. Additionally, Congress should define the term 'trading unit' and the correlation to risk-mitigating hedging activities in the legislation to ensure that banking entities may continue to hedge adequately their trades with institutional clients.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:

"(C) 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. In developing and issuing regulations pursuant to this section, the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission shall consider coordinated aggregate risk-mitigating hedging activities implemented across trading units. For purposes of this section, the term "trading unit" means each discrete unit engaged in a revenue generation strategy at a banking entity.

ii. Municipal Bond Market Exemption

Section 619(d)(1)(A) permits the purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof, as well as obligations of any State or of any political subdivision thereof. While we support this exemption, the Association is concerned that the Agencies' Proposed Rule has been drawn too narrowly, prohibiting banks from trading in a significant portion of the current municipal bond activities, including securities issued by State agencies or instrumentalities. We also disagree with the Agencies' interpretation that its exemption is "consistent with the statutory language," because it does not extend the government obligations exemption to include "transactions in obligations of an *agency* of any State or political subdivision thereof." Without clarification from Congress, the Agencies' current interpretation could have significant unintended consequences, such as limiting the funding availability for projects such as hospitals, affordable housing developments, airports, and universities that receive financing through municipal obligations.

Suggested Change: Congress should clarify the exemption for proprietary trading in State or municipal agency obligations through adopting the definition of "municipal securities" already included in Section 3(a)(29) of the Securities Exchange Act of 1934. Utilizing such a definition in the exemption would provide a clearer line for banks to follow regarding what is covered under the municipal bond market exemption, permitting investors to continue investing in municipal debt at reasonable costs.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:
"(A) The purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.), ~~and obligations of any State or of any political~~

~~subdivision thereof~~ and 'municipal securities,' as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c).

b. Covered Funds

i. Definition of "Covered Fund"

Section 619(h)(2) of the Dodd-Frank Act defines "hedge fund" and "private equity fund" as:

> an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine.

The Financial Stability Oversight Council's (FSOC) study on the Volcker Rule acknowledged that the foregoing definition is over-inclusive, and includes funds that are not commonly understood to be either a "hedge fund" or a "private equity fund" and that do not present the same types of risks. It also acknowledged that the definition is under-inclusive and may not capture other vehicles that don't rely on the exemptions, but engage in the activities or share the characteristics of a traditional private equity fund or hedge fund.

In drafting a definition, the FSOC study also recommended that certain factors be considered in determining what funds should be included as "similar funds." Accordingly, the Association believes this language must be tightened up in order to provide the Agencies with better guidance regarding what types of funds should be identified as "similar funds." Under the Proposed Rule, given the lack of guidance, the Agencies have extended this section to other types of funds without actually identifying the characteristics or activities that make such funds problematic or demonstrating that these funds lack adequate regulation by foreign jurisdictions.

For example, the Agencies have proposed to extend the definition of "covered fund" to cover any issuer organized or offered outside of the U.S. which would be a 3(c)(1) or 3(c)(7) fund if offered or organized inside the United States. Since most foreign funds could not meet all of the substantive regulatory requirements of a registered domestic investment company, they necessarily rely on the exemptions of Section 3(c)(1) or 3(c)(7). Thus, this definition captures a significant portion of foreign funds without adequate analysis of whether they share the same attributes as traditional hedge funds or private equity funds.

Additionally, the Agencies proposed to include as similar funds all "commodity pools" (which broadly captures vehicles that trade in commodity interests), as well as the foreign equivalent of any commodity pool and treat them as a "covered funds." According to the Agencies, these entities would be included because they are generally managed and structured similar to a covered fund except that they are generally not subject to the Federal securities laws due to the instruments in which they invest or because they are not organized in the U.S. or one or more States. We do not

believe it was Congress' intent to include these funds, because they do not have similar characteristics or activities of traditional hedge funds and private equity funds.

Further, in the wake of the CFTC's recent repeal of the Rule 4.5 exemption for mutual funds from the definition of commodity pools, and the expansion of the types of instruments that constitute "commodity interests" (i.e., swaps), many mutual funds and other pooled vehicles are likely to fall under the definition of commodity pools even if they trade in relatively small amounts of commodity interests. This may now subject many otherwise exempt registered investments companies to the Volcker Rule because commodity pools are considered "covered funds."

Suggested Change: Congress should revise and narrow the definition of "hedge fund" or "private equity fund" to exclude all registered investment companies and specifically identify the factors (i.e., characteristics and/or activities) that must exist in other pooled vehicles before the regulators may designate them as "similar funds." Additionally, foreign funds that are not actively marketed to U.S. investors and non-U.S. regulated funds, such as UCITS funds and other European regulated funds, which are subject to a degree of supervisory regulation in foreign jurisdictions (such as AIFMD), should also be excluded from the definition.

Legislative Text:
"(h) DEFINITIONS.—In this section, the following definitions shall apply:
"(2) HEDGE FUND; PRIVATE EQUITY FUND.—The terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine, provided that such fund demonstrates characteristics that are similar to traditional hedge funds and private equity funds, such as being a managed portfolio of investments that utilizes significant leveraging or high-risk strategies such as long, short, and derivative positions that increase risk or loss to the fund. The terms 'hedge fund' and 'private equity fund' shall not include: foreign funds that are not actively marketed to U.S. investors and non-U.S. regulated funds, when such funds and their advisers are subject to prudential standards in a home country that are administered and enforced by a comparable foreign supervisory authority

ii. Exemptions

A. Naming Prohibition

Section 619(d)(1)(G)(vi) provides that the banking entity may not share with the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the name. The Agencies' Proposed Rule expands upon this prohibition, stating that the covered fund may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof) and also may not use the word "bank" in the name.

Under Section 619(d)(1)(G)(v), the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests. This restriction is sufficient for ensuring that the entities are viewed separately in the market. We question the necessity for any naming prohibition beyond prohibiting the use of the word "bank" when a prohibition on bailing out funds is in place and where there is disclosure that investors bear the risk of loss in any default. The prohibition on bailing out funds protects against the "too big to fail" problems of the financial crisis and the disclosure requirements provide the necessary warning to investors of the risks involved.

Suggested Change: Congress should amend this provision to prohibit the word "bank" from the names of hedge funds or private equity funds organized and offered by banking entities, without requiring that the fund not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof). As currently drafted, the naming prohibition burdens the industry without providing increasing safeguards to investors. Under the Volcker Rule, banking entities may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the fund or of any fund in which such covered fund invests, and this must be disclosed in writing to prospective and actual investors. This restriction is sufficient for ensuring that the entities are viewed separately in the market.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:
"(G) Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, including any necessary expenses for the foregoing, only if—
"(vi) the name of the ~~banking entity does not share with the~~ hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, ~~the same name or a variation of the same name~~ does not include the word 'bank;'

B. Investments by Employees and Directors Providing Advisory or Other Services

Section 619 (d)(1)(G)(vii) prohibits any director or employee of the banking entity from taking or retaining an equity interest, partnership interest, or other ownership interest in the hedge fund or private equity fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the hedge fund or private equity fund.

Suggested Change: The Association believes that this prohibition on employee investment needs to be applied prospectively. Legislation should provide a grandfathering safe harbor for current

directors or employees to retain the interests already in their possession as of July 21, 2012, whether or not the directors or employees are currently providing services to the hedge fund or private equity fund. To do otherwise would cause these investors to suffer potentially significant tax consequences, as well as cause the funds and these investors significant difficulties in situations where interests are currently illiquid due to contractual redemption restrictions or the fund assets are illiquid.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:
"(G) Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, including any necessary expenses for the foregoing, only if—
"(vii) on or after the effective date, no director or employee of the banking entity ~~takes or retains~~ acquires an equity interest, partnership interest, or other ownership interest in the hedge fund or private equity fund, unless ~~except for any~~ the director or employee of the banking entity ~~who~~ is directly engaged in providing investment advisory or other services to the hedge fund or private equity fund; and

iii. Super 23A

Section 619(f)(1) prohibits a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund pursuant to Section 619(d)(1)(G), and no affiliate of such entity, to enter into a transaction with a fund, or with any other hedge fund or private equity fund that is controlled by such fund, that would be a covered transaction, as defined in Section 23A of the Federal Reserve Act, with the hedge fund or private equity fund, as if such banking entity and the affiliate thereof were a member bank and the hedge fund or private equity fund were an affiliate thereof.

Under the additional restrictions created by this provision, banks and their affiliates would not be able to engage in limited types of covered transactions currently permitted by the exclusions and restrictions under Section 23A when lending to affiliates. Unlike the regulations between banks and their affiliates, where limitations exist but banks are still able to lend, this provision would make it so that advisers are no longer permitted to lend money to funds in the same way as is available for banks to lend to operating affiliates. In practice, this provision would allow banks to engage in more extensive activities with affiliated entities (where the bank's capital is at greatest potential risk of loss) than would be permitted between a bank or its affiliate and an affiliated hedge fund (where the bank's risk of capital loss is less).

The Association also questions the necessity to restrict activity more tightly between banks and affiliates when the banks are engaged in the traditional functions of custodian banks. Custodian banks that also manage covered funds must be able to continue to provide custodian services, such as providing intraday and overnight credit in connection with routine security and currency deliveries of payment transactions. If custodian banks are unable to provide custodian services to affiliated funds in the same manner as unaffiliated funds, then more risk would be introduced into the settlement process for these affiliated funds, because they would have to introduce third party custodians or lending parties to offer intraday or overnight credit to provide the necessary liquidity for routine payment and settlement functions. This would create more disconnect in the securities payment and settlement processing system, and will commensurately increase operational risk to these funds as well as the securities payment or settlement system. Ultimately, this would increase the potential risk to the fund sponsor. In other words, the fund may be more likely to suffer a loss that otherwise could have been anticipated and managed with an affiliated custodian because that custodian has a comprehensive view of the fund's activities and shares an interest to minimize risk of loss caused by disruptions in securities payment and settlements processing.

Suggested Change: The Association suggests that the legislation should modify this provision to mirror the language of Section 23A of the Federal Reserve Act, permitting banks and their affiliates to engage in limited types of covered transactions permitted by the current exclusions and restrictions under the Federal Reserve Act when lending to affiliates. Additionally, the language should clarify that banks may continue to engage in the traditional functions of custodian banks.

Legislative Text:
"(f) LIMITATIONS ON RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS.—
"(1) IN GENERAL.— A ~~No~~ banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund pursuant to paragraph (d)(1)(G), and all ~~no~~ affiliates of such entity, ~~may enter into a transaction with a fund, or with any other hedge fund or private equity fund that is controlled by such fund, that would be a covered transaction, as defined in~~ shall abide by the restrictions on transactions with affiliates described in section 23A of the Federal Reserve Act (12 U.S.C. 371c) with the hedge fund or private equity fund, as if such banking entity ~~and the affiliate thereof~~ were a member bank and the hedge fund or private equity fund were an affiliate thereof.

iv. Limitations on Fund Investments

Under Section 619(d)(4)(B)(ii)(I) of the Dodd-Frank Act, banking entities may take an ownership interest in a covered fund if the banking entity's investment is limited to no more than three percent of the total outstanding ownership interests of such fund not later than one year after the date of establishment of the fund. The banking entity may also not invest more than three percent of its Tier 1 capital in covered funds in the aggregate.

Typically, bank asset managers will market affiliated funds that have at least a three-year performance record in order to attract institutional investors. In order to create such a longstanding record, the manager will typically seed a strategy for the initial three years with capital. Few asset managers or investors are willing to invest in a strategy that does not have a three-year performance record. Because of the broad application of the Volcker Rule to bank-affiliated managers, the three percent restriction will severely curtail a bank-affiliated manager from investing its own money to create the three-year performance record, and effectively eliminate an adviser's ability to launch new strategies that are not 40 Act Funds.

Suggested Change: The Association suggests that the legislation should modify the one-year deadline, instead requiring a three-year deadline to limit fund investment. By doing so, the Congressional goal of ensuring banks are not engaging in risky behavior will be met, while still allowing bank asset managers who market affiliated funds to establish their performance record needed in order to attract institutional investors. If appropriate, such three-year extension could be contingent on the per fund investment be subject to a dollar limit and otherwise be explicitly subject to the aggregate investment limit of 3% of Tier 1 capital of the banking entity.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(4) DE MINIMIS INVESTMENT.—
"(B) LIMITATIONS AND RESTRICTIONS ON INVESTMENTS.—
"(ii) LIMITATIONS ON SIZE OF INVESTMENTS.—Notwithstanding any other provision of law, investments by a banking entity in a hedge fund or private equity fund shall—
"(I) not later than ~~1~~ 3 years after the date of establishment of the fund, be reduced through redemption, sale, or dilution to an amount that is not more than 3 percent of the total ownership interests of the fund, provided that the appropriate Federal banking agencies may impose a dollar limit on the banking entity's investment in an individual hedge fund or private equity fund during its initial 3 year term to address potential undue risk to the banking entity's capital;

v. Definition of Illiquid Fund

Section 619(h)(7) of the Dodd-Frank Act defines illiquid fund as a hedge fund or private equity fund that "as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments, and makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets."

The Association believes this definition utilizes an arbitrary date that may unnecessarily exclude funds that otherwise should meet the definition of being an illiquid fund. While we recognize that the purpose of this definition is to ensure that people are unable to manipulate the system, this definition would exclude, for example, a fund that was entirely liquid on May 1, 2010, but ultimately found itself in an illiquid state due to reasons or factors beyond its control (for example, the illiquidity was not due to any changes in portfolio holdings but was due to market forces). Such a result would harm investors to such funds and cut against the Congressional intent in Section 619 of

the Dodd-Frank Act. It would also not take into account liquidity factors that adversely affect the fund and are beyond the control or foresight of the fund sponsors. This could require sponsors to divest their fund ownership interest at inopportune times (i.e.., when market liquidity is constrained) despite best efforts to reduce their ownership interests by the deadline.

Suggested Change: The definition of illiquid fund should be based on assets rather than being solely based on contractual rights at a specific date in the past. The definition should also provide flexibility for regulators to implement a process for a banking entity to apply for an extension of time to divest its ownership interest in the fund in order to minimize the adverse impacts on, and conflicts of interest with, the fund and the investors, particularly where forcing the banking entity to divest prematurely could abrogate pre-existing contractual agreements or fundamental tenets of the fund's structure and operation. Such application process would allow the regulators to individually analyze whether a fund in existence prior to the statute's enactment has become illiquid through reasons beyond the fund or sponsor's control, and provide for a more tailored and orderly divestment based on the particular facts and circumstances. Further, the legislation should clarify that all funds that otherwise meet the definition of being principally invested in illiquid assets as of the date of implementation are grandfathered in as illiquid funds under the statute, rather than using the date of May 1, 2010.

Legislative Text:
"(h) DEFINITIONS.—In this section, the following definitions shall apply:
"(7) ILLIQUID FUND.—
"(A) IN GENERAL.—The term 'illiquid fund' means a hedge fund or private equity fund that—
"(i) ~~as of May 1, 2010, was~~ (a) on or prior to the enactment date, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments; and
"(~~ii~~b) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets; or
(ii) on or after the enactment date, held liquid assets of which a significant portion became illiquid due to market forces or factors beyond the individual or collective control of such fund, its investment adviser and its sponsor. In issuing rules regarding this subparagraph, the Board shall take into consideration the terms of investment for the hedge fund or private equity fund, including contractual obligations, the ability of the fund to divest of assets held by the fund at a reasonable price, whether the fund has become illiquid through factors or reasons beyond the individual or collective control of the funds, its investment adviser or sponsor, and any other factors that the Board determines are appropriate.

CONCLUSION

The Association recognizes the challenges Congress and the Agencies have in attempting to draft legislation and regulations to limit potentially risky banking activities while permitting banks to continue to provide much needed liquidity. The Association thanks HFSC for the opportunity to provide our suggestions regarding how Section 619 of the Dodd-Frank Act could be improved. We would be happy to discuss these changes with you or the Committee at your convenience. Please

feel free to contact me with any questions you may have at jgidman@loomissayles.com or (617) 748-1748.

On behalf of the Association of Institutional INVESTORS,

John Gidman
President

cc: Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission
Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve
Mr. Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation
Mr. David A. Stawick, Secretary, Commodity Futures Trading Commission
Mr. Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency

APPENDIX A

SUGGESTED LEGISLATION TEXT

112TH CONGRESS
2ND SESSION

H.R._____

To amend certain provisions in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

_____, ____ 2012

Mr. Bachus introduced the following bill; which was referred to the House Financial Services Committee.

A BILL

To amend certain provisions in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and for other purposes.

1 *Be it enacted by the Senate and House of Representatives of*
2 *the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE.**
4 (a) Short Title — This Act may be cited as the "Volcker Act".
5 (b) Reference — Whenever in this Act an amendment or repeal is
6 expressed in terms of an amendment to, or repeal of, a section or
7 other provision, the reference shall be considered to be made to a
8 section or other provision of the Dodd-Frank Wall Street Reform
9 and Consumer Protection Act of 2010.

1 **SECTION 2. PERMITTED ACTIVITIES**

2 (a) Section 619(d)(1)(A) (12 U.S.C. 1851(d)(1)(A)) is amended by
3 striking "and obligations of any State or of any political subdivi-
4 sion thereof" and inserting "any 'municipal securities,' as defined
5 in Section 3(a)(29) of the Securities Exchange Act of 1934 (15
6 U.S.C. 78c)."

7 (b) Section 619(d)(1)(B) (12 U.S.C. 1851(d)(1)(B)) is amended to
8 read as follows: "(B) The purchase, sale, acquisition, or disposi-
9 tion of securities and other instruments described in subsection
10 (h)(4) in connection with underwriting or market-making related
11 activities reasonably related to customer facilitation or intermedia-
12 tion, to the extent that any such activities permitted by this sub-
13 paragraph are designed not to exceed the reasonably expected near
14 term demands of clients, customers, or counterparties. For pur-
15 poses of this section, the term "reasonably expected near term de-
16 mands" shall be based on the specific liquidity characteristics of
17 individual markets and products."

18 (c) Section 619(d)(1)(C) (12 U.S.C. 1851(d)(1)(C)) is amended by
19 inserting "In developing and issuing regulations pursuant to this
20 section, the appropriate Federal banking agencies, the Securities
21 and Exchange Commission, and the Commodity Futures Trading
22 Commission shall consider coordinated aggregate risk-mitigating
23 hedging activities implemented across trading units. For the pur-
24 poses of this section, the term "trading unit" means each discrete
25 unit engaged in a revenue generation strategy at a banking entity"
26 after the period.

1 (d) Section 619(d)(1)(G)(vi) (12 U.S.C. 1851(d)(1)(G)(vi)) is
2 amended to read as follows: "(vi) the name of the hedge fund or
3 private equity fund, for corporate, marketing, promotional, or
4 other purposes, does not include the word 'bank;'"
5 (e) Section 619(d)(1)(G)(vii) (12 U.S.C. 1851(d)(1)(G)(vii)) is
6 amended to read as follows: "(vii) on or after the effective date, no
7 director or employee of the banking entity acquires an equity in-
8 terest, partnership interest, or other ownership interest in the hedge
9 fund or private equity fund, unless the director or employee of the
10 banking entity is directly engaged in providing investment advi-
11 sory or other services to the hedge fund or private equity fund;
12 and"
13 (f) Section 619(d)(4)(B)(ii)(I) is amended —
14 (1) by striking "1 year" and inserting "3 years"; and
15 (2) by inserting before the semi colon the following: ", provided
16 that the appropriate Federal banking agencies may impose a dollar
17 limit on the banking entity's investment in an individual hedge
18 fund or private equity fund during its initial 3 year term to address
19 potential undue risk to the banking entity's capital".

20 **SECTION 3. LIMITATIONS ON RELATIONSHIPS WITH**
21 **HEDGE FUNDS AND PRIVATE EQUITY FUNDS**

22 Section 619(f)(1) (12 U.S.C. 1851(f)(1)) is amended to read as fol-
23 lows: "(1) IN GENERAL — A banking entity that serves, directly
24 or indirectly, as the investment manager, investment adviser, or
25 sponsor to a hedge fund or private equity fund, or that organizes
26 and offers a hedge fund or private equity fund pursuant to para-
27 graph (d)(1)(G), shall abide by the restrictions on transactions with

1 affiliates described in section 23A of the Federal Reserve Act (12
2 U.S.C. 371c) with the hedge fund or private equity fund, as if such
3 banking entity were a member bank and the hedge fund or private
4 equity fund were an affiliate thereof."

5 **SECTION 4. DEFINITIONS**

6 (a) Section 619(h)(2) (12 U.S.C. 1851(h)(2)) is amended by insert-
7 ing "provided that such fund demonstrates characteristics that are
8 similar to traditional hedge funds and private equity funds, such as
9 being a managed portfolio of investments that utilizes significant
10 leveraging or high-risk strategies such as long, short, and deriva-
11 tive positions that increase risk or loss to the fund. The terms
12 'hedge fund' and 'private equity fund' shall not include foreign
13 funds that are not actively marketed to U.S. investors and non-U.S.
14 related funds, when such funds and their advisors are subject to
15 prudential standards in a home country that are administered and
16 enforced by a comparable foreign supervisory authority" before
17 the period.

18 (b) Section 619(h)(4) (12 U.S.C. 1851(h)(4)) is amended to read as
19 follows: "(4) PROPRIETARY TRADING —The term 'proprie-
20 tary trading', when used with respect to a banking entity or non-
21 bank financial company supervised by the Board, means, subject
22 to the following sentence, engaging as a principal for the trading
23 account of the banking entity or nonbank financial company su-
24 pervised by the Board in any transaction to purchase or sell, or
25 otherwise acquire or dispose of, any security, any derivative, any
26 contract of sale of a commodity for future delivery, any option on
27 any such security, derivative, or contract, or any other security or

1 financial instrument that the appropriate Federal banking agencies,
2 the Securities and Exchange Commission, and the Commodity Fu-
3 tures Trading Commission may, by rule, as provided in subsection
4 (b)(2), determine. For purposes of this definition, the term 'pro-
5 prietary trading' is limited to principal transactions effected for the
6 purpose of executing trading strategies that are expected to pro-
7 duce short-term profits without a clear connection to customer fa-
8 cilitation or intermediation."
9 (c) Section 619(h)(7)(A) (12 U.S.C. 1851(h)(7)(A)) is amended to
10 read as follows:
11 "(A) IN GENERAL — The term 'illiquid fund' means a hedge
12 fund or private equity fund that —
13 "(i) (a) on or prior to the enactment date, was principally invested
14 in, or was invested and contractually committed to principally in-
15 vest in, illiquid assets, such as portfolio companies, real estate in-
16 vestments, and venture capital investments; and
17 "(b) makes all investments pursuant to, and consistent with, an in-
18 vestment strategy to principally invest in illiquid assets; or
19 "(ii) on or after the enactment date, held liquid assets of which a
20 significant portion became illiquid due to market forces or factors
21 beyond the individual or collective control of such fund, its in-
22 vestment adviser and its sponsor. In issuing rules regarding this
23 subparagraph, the Board shall take into consideration the terms of
24 investment for the hedge fund or private equity fund, including
25 contractual obligations, the ability of the fund to divest of assets
26 held by the fund at a reasonable price, whether the fund has be-
27 come illiquid through factors or reasons beyond the individual or

1 collective control of the fund, its investment adviser or sponsor,
2 and any other factors that the Board determines are appropriate."
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APPENDIX B

Comments of the Association of Institutional INVESTORS
In Response to the Financial Regulators Request for Comments on its Proposed Rule Titled:
Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships
With, Hedge Funds and Private Equity Funds
February 13, 2012

February 13, 2012

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
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Mr. John G. Walsh
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
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Washington, D.C. 20219

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (SEC File Number S7-41-11; FRS Docket No. R-1432 & RIN 7100 AD 82; FDIC RIN 3064-AD85; OCC Docket ID OCC-2011-14; CFTC RIN 3038-AD05).

Dear Sirs and Madams,

The Association of Institutional INVESTORS (the "Association")[1] appreciates the opportunity to provide comments related to the proposed rule titled, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds" (the "Proposed Rule").[2] The Association recognizes the efforts undertaken by the Securities and

[1] The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

[2] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011). We recognize the CFTC did not join the other prudential

Exchange Commission ("SEC"), Board of Governors of the Federal Reserve ("Federal Reserve"), Federal Deposit Insurance Corporation ("FDIC"), Office of the Comptroller of the Currency ("OCC"), and Commodity Futures Trading Commission ("CFTC" and together with the other agencies, the "Agencies") to implement rules regarding proprietary trading and restrictions on relationships with covered funds, as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] However, the Association has some concerns with the Proposed Rule relating to both the proprietary trading restrictions and the restrictions on covered fund activity.

The Association represents asset managers that work on behalf of institutional investors, such as pension funds and 401(k) accounts. Although this rulemaking is focused on the activities of banks, we believe that the Proposed Rule will negatively affect the clients of institutional asset managers, and therefore have consequences for millions of American investors who rely on the continued vitality of these pension plans and 401(k) accounts. We are concerned that the implementation of the Volcker Rule as currently constructed will result in a reduction in the breadth of investment options available to the marketplace, as bank dealers exit lines of business due to increased compliance costs and uncertainty about the boundaries of permissible and impermissible activities. The Proposed Rule may also diminish the depth of both liquid and illiquid sectors of the market because the complex nature and interplay of the factors and metrics proposed in the rule are impracticable to implement.

The unintended consequences of this well intentioned Proposed Rule may be to deepen and extend the current economic downturn.

I. PROPRIETARY TRADING RESTRICTIONS

The Association is concerned that the Proposed Rule, as currently drafted, may fundamentally change how, or whether, banks will be willing to serve as major liquidity providers. We believe that the Proposed Rule offers arbitrary and complex tests for determining whether a bank meets the exemptions from the proprietary trading restrictions, which do not adequately reflect the realities of the financial markets. We are concerned that unless significant changes are made to the Proposed Rule, our institutional investment clients will be negatively affected.

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regulators in issuing the Proposed Rule. However, because the Association preliminarily believes the CFTC's proposed rule, RIN 3038-AD05, which has not yet been published in the Federal Register, will be substantially similar to the Proposed Rule, we have determined that it is appropriate to provide the CFTC with the Association's comments at this time. The Association believes that it is important for the CFTC to consider these comments because the prudential regulators must issue final joint regulations together.

[3] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010). Further, although the Association appreciates the Agencies' efforts to implement Section 619 of the Dodd-Frank Act, we also recognize the arguments made by others, including Chairman of the House Financial Services Committee Spencer Bachus (R-AL), who have called for Congress to reevaluate the provision, stating that Section 619 creates a "self-inflicted wound" on the U.S. markets and have noted that other efforts, such as implementing the Basel III capital requirements, may more properly address bank risk taking addressed by the Volcker Rule. *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (opening statement of Rep. Spencer Bachus, Chairman, H. Comm. on Financial Services).

Asset managers and their clients rely on banks to execute trades. Anecdotal evidence suggests that in today's market well more than half of institutional investment adviser transactions consist of trades with banks, including foreign banks. In this role, banks are providing critical services for the functioning of the secondary market. While we understand that the regulators' intention is not to inhibit banks' legitimate market making functions, we remain concerned that unless changes are made to the Proposed Rule, market making activities will be curtailed, causing negative (though unintended) consequences for institutional and individual investors.

In particular, the Proposed Rule's definitions relating to permitted activities do not recognize key differences between markets with continuous liquidity versus episodic liquidity. In markets with episodic liquidity, such as many fixed income markets, banks do not simply engage in agency trading without risk, only buying from a client or an investor seller when they already have counterparty demand and know the price that they will be able to sell the asset. Instead, traditional market making entails banks being able to hold inventory on their books, assuming the role of being a direct counterparty to the client or investor seller. In such a situation, banks will buy illiquid assets from sellers such as asset managers acting on behalf of their clients even if the bank has not yet found a buyer for such assets, agreeing to hold the assets until another buyer wishes to purchase them, which may occur quickly in some situations and slowly in others.

The potential for the Proposed Rule to restrict a bank's ability to engage in principal-based trading and to cause a bank to convert to an agency trading model, where buyers and sellers must be matched before a trade is executed, may have devastating effects on an asset manager's ability to serve the needs of the institutional investors, such as ERISA pension and 401(k) plans. A bank's willingness to take on this risk in order to facilitate customer transactions and hold assets in dealer inventory until a willing buyer is found is essential in less liquid markets because it allows an asset manager to choose which assets it wishes to sell to meet redemption requests from institutional investors. Without it, asset managers may be forced to do a "fire sale" of illiquid assets, or simply sell what assets it *can* sell, not what assets it *wants* to sell. This will result not only in the loss of assets that the asset manager otherwise wanted to retain for the client, but also in the residual portfolio becoming increasingly illiquid. An increasingly illiquid portfolio is harmful to the remaining investors. As liquidity concerns rise, an asset manager may also have to carry additional cash to ensure that it can pay redemption orders at a customer's request. Alternatively, it may be necessary in some cases, where possible, for an asset manager to place additional restrictions on when investors can redeem their money out of a fund. In many cases it may also be difficult or impossible for an asset manager to amend restrictions on various types of funds, including ones established under the Investment Company Act of 1940 ("40 Act Funds"), which have regulations governing redemption requests.

Even if dealers are still willing to make markets for institutional investment advisers, the Proposed Rule may also negatively affect investors by reducing market depth and raising costs. Currently, banks provide investors with choice, offering securities with varying characteristics. The Proposed Rule may cause banks to limit the securities kept in inventory, depleting the pool of available securities for investors and affecting the ability of investors to efficiently manage their portfolios. Further, we believe this Proposed Rule will significantly raise costs for investors, including institutional investors such as pension funds and 401(k) accounts, because the compliance costs for banks will inevitably be passed on to investors.

Bid-ask spreads will also widen, reducing the ultimate return investors will receive. By limiting when banks can engage in principal-based trading, the natural result will be that the difference between the price a buyer is willing to pay for a security, compared with the price in which a seller is willing to sell a security, will increase. These costs, coupled with a tightening of liquidity in the market, will negatively affect the ability of pension funds and 401(k) accounts to function in the most effective manner. By taking on reasonable risk and principal positions, banks enable markets with otherwise episodic liquidity to operate in a vibrant and efficient way for millions of American investors.[4]

In addition to adversely affecting the secondary markets by decreasing liquidity and the depth of markets, the Proposed Rule also has the potential to distress primary markets. Without a vibrant secondary market for fixed income securities, for example, underwriters in the primary market will be less likely to underwrite debt offerings, resulting in fewer options for institutional investors, and U.S. companies will be forced to borrow directly from banks for their capital needs. Complicating this situation, since the economic downturn, many banks are unwilling or unable to lend, which will exacerbate American business's ability to access capital, grow the economy, and create jobs.

To address these concerns, we believe the Agencies should focus on client activity when drafting a workable test for the markets, starting from a presumption that the bank is engaged in permitted activity, rather than presuming that the trading activity is proprietary unless the bank can meet one of the permitted activity tests. The Proposed Rule essentially characterizes banks as guilty until proven innocent, which the Association believes is an unwise and unsound position that will result in numerous negative consequences. As discussed in further detail below, the Association is particularly concerned with potential negative consequences that could result from the Agencies' narrow interpretations of: (1) the market maker exemption; (2) the risk mitigating hedging exemption; and (3) the municipal bond exemption.

A. Presumption of Proprietary Trading

The exemptions enumerated in the Proposed Rule require banks to meet a set of criteria to show that they are not engaged in proprietary trading, creating a presumption that the activity *is* proprietary trading unless the banks prove otherwise. This is inconsistent with congressional intent and may result in banks being unwilling to take principal risk to provide liquidity services to institutional investors. Unless this is changed, the Proposed Rule would allow the Agencies to second-guess a bank's actions after it has completed trades, making it difficult or risky for the bank to assist asset managers in executing such trades. This result may unnecessarily constrain liquidity in secondary markets and cause asset managers and others to look to alternative non-U.S. markets to service client needs. Such actions may also decrease transparency in the marketplace, in direct contrast to the Dodd-Frank Act's stated goals, and result in the U.S. losing market share, potentially hurting the still-fragile economy.[5]

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[4] In that regard, we note that while retail investors generally trade equity securities on exchanges (on a commission-basis through an agent), fixed-income markets are more commonly sold on a bid-ask spread through a principal intermediary, and thus, will be greatly impacted by the Proposed Rule. Further, even though a substantial portion of equity trading is conducted on an agency basis, a considerable amount of equity trades entered into by the funds and accounts managed by our members is traded on a principal basis and will, therefore, also be impacted.

[5] *See* 156 CONG. REC. S5912-13 (daily ed. July 15, 2010) (statement of Sen. Leahy (D-VT)): "The conference report we are voting on today goes directly to the heart of the Wall Street excesses that brought our economy to the brink. For far too long Wall Street firms made risky bets in the dark and reaped enormous profits. Then, when their bets went sour,

During the Dodd-Frank Act Conference Committee negotiations, Senator Jeff Merkley (D-OR) noted that the Agencies can distinguish proprietary trading from market making based on, "volume of trading, the size of the positions, the length of time that positions remain open, and the volatility of profits and losses."[6] While we agree that these factors may generally help differentiate market making from proprietary trading, if implemented incorrectly, these same factors could unnecessarily constrict what a bank is willing, or even able, to accomplish and likely lead to liquidity drying up for the secondary market, which Congress was trying to avoid by including the market making exemption.[7]

Under the Proposed Rule's market making exemption test, regulators will scrutinize behavior after-the-fact and may "discover" proprietary trading, when banks were actually engaged in market making. Ambiguities in the test and uncertainty as to whether the Agencies will interpret legitimate behavior as proprietary trading may make it difficult for banks to remain in this role. Congress noted that market making is a "customer service," assisting customers in the "speedy acquisition or disposition of certain financial instruments."[8] If banks are unwilling to continue intermediating trades for institutional investors because the Proposed Rule creates uncertainty as to whether such activity is market making, the ultimate harm will fall on individuals and families, who utilize pension funds and 401(k) funds for their retirement savings.

This presumption will limit the tools available to asset managers to hedge and diversify their risk exposure. It will create problems not only for fixed-income markets, but also for equity markets, including millions of individuals invested through retail accounts and workplace retirement plans such as 401(k) accounts. While retail investors and smaller institutional investors often trade equities using an agency-based "last sale" model, larger investors trade in a myriad of ways with covered banking entities in an effort to reduce execution costs, mitigate risk, and improve returns. It is

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they turned to America's taxpayers to bail them out. This bill is about changing the culture of rampant Wall Street speculation and doing what needs to be done to get our economy back on track. We need more transparency and oversight of Wall Street. These improvements will increase transparency in and oversight of the financial sector . . . It has seemed to me that promoting transparency should be a vital element of Wall Street reform. Transparency is a cleansing agent for healthy markets. Open information helps investors make sound decisions. When information is murky, market decisions must be based on guesses or rumors that corrode trust and that encourage fraud and deception."

[6] *See* 156 CONG. REC. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley (D-OR)): "Market-making is a customer service whereby a firm assists its customers by providing two-sided markets for speedy acquisition or disposition of certain financial instruments... Academic literature sets out the distinctions between making markets for customers and holding speculative positions in assets, but in general, the two types of trading are distinguishable by the volume of trading, the size of the positions, the length of time that positions remains open, and the volatility of profits and losses, among other factors. Regulations implementing this permitted activity should focus on these types of factors to assist regulators in distinguishing between financial firms assisting their clients versus those engaged in proprietary trading."

[7] *See* 156 CONG. REC. S5906 (daily ed. July 15, 2010) (statement of Sen. Bayh(D-IN)): "With respect to the Volcker Rule, the conference report states that banking entities are not prohibited from purchasing and disposing of securities and other instruments in connection with underwriting or market making activities, provided that activity does not exceed the reasonably expected near term demands of clients, customers, or counterparties. I want to clarify this language would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function. Without that flexibility, market makers would not be able to provide liquidity to markets."

[8] *See* 156 CONG. REC. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley (D-OR)).

crucial for advisers to large institutional clients to have access to covered banking entities' traditional equity securities market making activities, including the ability to enter into block trades and hedge without undue restriction, so that end investors are not subject to unnecessary increased risk and costs.

Similarly, the ability of institutional investors to continue to use over-the-counter (OTC) derivatives products to safely diversify their portfolios and effectively hedge or manage risks may also be impaired unless the presumption is changed. Activity in OTC derivatives markets can easily be misinterpreted as proprietary trading because market makers in this asset class usually act as principals who take positions in instruments with episodic liquidity in order to facilitate customer needs. Market making is also fundamental to OTC derivatives trading, as dealers use derivatives as part of their overall fixed income or equity trading to hedge out risk on a portfolio basis. Unless the market making exemption is sufficiently expanded to ensure that banks may continue to act as market makers with respect to OTC derivatives, the result for our investment funds, and ultimately our investors, will be diminished liquidity, less portfolio diversification, less ability to hedge, and increased costs. Also, in the event that banks limit their OTC derivatives trading as a result of the Proposed Rule, it would lead to less counterparty diversification, which increases counterparty risk for the funds and accounts managed by our members.

We recognize that determining the exact criteria to be used in defining proprietary trading is difficult. With that said, we agree with Federal Reserve Governor Daniel Tarullo that while some trades are "textbook examples" of proprietary trading or market making, the majority of trades include buyers and sellers arriving "at different times, in staggered numbers, and often have demands for similar but not identical assets."[9] Therefore, the Association suggests that the Agencies make the rule simpler, focusing on "trading activities that are organized within a discrete business unit, and that are conducted solely for the purpose of executing trading strategies that are expected to produce short-term profits without any connection to customer facilitation or intermediation," in defining proprietary trading, in a way which is, "not difficult to identify."[10] By doing so, the Agencies would be consistent with former Federal Reserve Chairman Paul Volcker's statements that it should be easy to recognize proprietary trading.[11]

We are disappointed with Governor Tarullo's statement that the Agencies considered and rejected simpler tests to determine proprietary trading. We disagree that such tests would "fail to adequately capture the full range of activities that are prohibited under the [Dodd-Frank Act]," because, as stated previously, even former Chairman Volcker believed that true proprietary trading should be easy to spot. We are concerned that the Agencies are attempting to determine motive and intent under the Proposed Rule, and urge the Agencies to make the distinction as clear as possible.[12] At a

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[9] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Federal Reserve Governor Daniel Tarullo).

[10] *See id.*

[11] *See e.g.* Lauren Tara LaCapra, *Paul Volcker Says Identifying Speculative Trading Is Easy*, REUTERS, May 4, 2011, http://www.reuters.com/article/2011/05/05/us-volcker-idUSTRE74385W20110505.

[12] House Financial Services Committee Chairman Spencer Bachus also noted concerns with the Agencies' attempt to determine motive and intent, stating "when we have to determine peoples' motive, we're on thin ice." *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and*

minimum, we hope that the Agencies will meet the expectation noted by House Financial Services Committee Ranking Member Barney Frank (D-MA), who said that banks should not have to worry about getting "too close to the line," because the agencies will not be predisposed to considering such market making activities to be proprietary trading.[13]

B. Market Making Exemption

As required under the statute, the Proposed Rule exempts market making activities.[14] In order to satisfy the market making exemption under the Proposed Rule, a banking entity must be able to *prove* that the activity meets a list of seven criteria, including: (1) establishment of an internal compliance program; (2) the activity must meet bona fide market making requirements; (3) trades must match the reasonably expected near-term demands of clients, customers, and counterparties; (4) the banking entity relying on the exemption must be appropriately registered under securities or commodities laws; (5) market making-related activities must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other similar income; (6) compensation incentives must not be designed to reward proprietary trading activities; and (7) consistency with the commentary attached to the rule in Appendix B.[15]

While the Association understands that it was "particularly challenging"[16] for the Agencies to determine how to distinguish permissible market making related activities from prohibited proprietary trading, the Proposed Rule's current exemption does not adequately fulfill the congressional goal of ensuring that legitimate market making activities remain permissible.[17] Instead, the market making exemptions' strict and complicated requirements, including: "(1) seven criteria that a banking entity's activities must meet to rely on the market making exception, including establishment of a compliance program; (2) six principles that the Agencies will use as a guide in distinguishing bona fide market making from prohibited proprietary trading; and (3) seventeen quantitative metrics that a banking entity with significant trading activities must report for each of its trading units at every level of the organization,"[18] will in fact jeopardize legitimate activity. Rather

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Government Sponsored Enterprises and Financial Institutions and Consumer Credit, 112th Cong. (Jan. 18, 2012) (statement of Rep. Spencer Bachus, Chairman, H. Comm. on Financial Services).

[13] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Rep. Barney Frank, Ranking Member, H. Comm. on Financial Services).

[14] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,848.

[15] *Id.*

[16] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Acting Comptroller of the Currency John Walsh).

[17] *See* 156 CONG. REC. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley (D-OR)): "Accordingly, while previous versions of the legislation referenced 'market-making,' the final version references "market- making-related" to provide the regulators with limited additional flexibility to incorporate those types of transactions to meet client needs, without unduly warping the common understanding of market-making."

[18] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Acting Comptroller of the Currency John Walsh).

than providing clear guidelines by which traders are encouraged to continue permissible trading, traders will likely restrict their activity out of fear of getting too close to the ambiguous line.

The Association is particularly concerned that the criteria requiring that trades, "match the reasonably expected near-term demands of clients, customers, and counterparties," may be too ambiguous to be meaningful. The "reasonably expected near-term demands of clients, customers, and counterparties," means different things in different markets – for certain illiquid markets, the "near-term" may be much longer than in other, more liquid, markets. While we recognize that this requirement is congressionally mandated, the Association urges the Agencies to construe it as narrowly as possible and define "near-term" in a way that considers the needs of markets that are illiquid or have episodic liquidity.

Requiring banks to prove that their activities are designed to "generate revenues from fees, commissions, bid-ask spreads or other similar income that is not related to proprietary trading"[19] does not adequately ensure that legitimate market making is protected because this test is an over-inclusive indicator. Banks engaged in market making do not always have a matched trade ready when the assets must be purchased from the asset manager. A bank facilitating client demand may hold an asset that will appreciate in value as it remains on the books until a willing buyer is located. The Proposed Rule will create fear that this appreciation may be deemed proprietary speculation and result in banks refraining from the market making that is essential to maintain market liquidity, particularly in fixed income markets. The Agencies should focus on ensuring positions taken by a bank relate to the customer activity, regardless of the magnitude or length the positions are held open, or whether the bank is acting as an agent or principal in the trade. As long as a bank's positions relate to customer activity, then its activities should be presumed to be market making, and not proprietary.

Further, the Association appreciates the Agencies' desire to maintain legitimate market making activities, but believes this could be achieved in a manner that presumes that a bank's activity is **not** proprietary trading unless proven otherwise. Since the Dodd-Frank Act passed, some banks have already begun discontinuing proprietary trading desks.[20] The industry has demonstrated, in advance of the Proposed Rule's effective date, that they understand and are willing to change their business models to comply with the purpose of the Proposed Rule. In light of these good faith efforts, we urge the Agencies to simplify the Proposed Rule to ensure that banks are able to continue those market making related activities that Congress intended to be protected, as our members rely on these activities for trading by the funds and accounts that they manage.

C. Risk Mitigating Hedging Activity

Section __.5 of the Proposed Rule, similar to the market making exemption, provides a number of requirements that firms must attain in order to rely on a risk-mitigating hedging exemption available

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[19] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,962.

[20] Liz Rappaport, *Goldman to Shut Global Macro Trading Desk*, WALL STREET JOURNAL, Feb. 15, 2011, http://online.wsj.com/article/SB10001424052748704409004576146702013530680.html (Goldman Sachs closed its Global Macro Proprietary Trading desk "to comply with the Volcker Rule.").

under Section 13 of the Bank Holding Company Act ("BHC").[21] According to the Proposed Rule, the criteria is intended to define the scope of permitted risk-mitigating hedging activities and to prohibit reliance on the exemption for proprietary trading that is mischaracterized as permitted hedging activity.[22]

The Association agrees that hedging is an appropriate indicator of an entity's risk appetite, but believes that this indicator breaks down at the trade-by-trade level. In particular, this indication fails when gauging whether hedging activities are proper for illiquid markets, where perfect hedges are often not available. Although we appreciate SEC Chairman Mary Schapiro's assurances, in response to a question from Ranking Member Barney Frank at a House Financial Services Committee hearing on the Volcker Rule, that the Agencies will not be looking at trading activity at the trade-by-trade level, we ask that the Agencies make this more explicit in the final rulemaking.[23] Without making this explicit in the final rulemaking, we worry that trades will still be looked at on an individual basis, potentially finding proprietary trading in situations that are not, when considered overall.[24]

Further, members of the Association work to reduce execution costs, mitigate risk, and improve returns for millions of investors in the funds and accounts that they manage. These goals are achieved by trading with market makers that use generally available hedges to bridge the gap between time and price with various traders in the market. The hedging exemption, therefore, must include a broad definition of what constitutes a "trading unit" (also known as an "aggregation unit") to permit banking entities to hedge adequately their trades with institutional clients.

If the Agencies interpret "trading unit" too narrowly, or if the market making exemption is too restrictive, the ability of funds to enter into block trades with banking entities could be significantly diminished, to the detriment of funds and their investors. Block trading is traditionally used when the size of the trade would strain the market and potentially result in increased execution costs, as a result of adverse market movements, and increased risk, because the trade requires an extended time period for completion. In order for a banking entity to fill this need, it may gauge risk across its entire platform, rather than across one trading desk, and agree to take positions on its books until an appropriate buyer is available. In doing so, banking entities are effectively mitigating risk.

If the Agencies look too narrowly at the hedging correlation, i.e., on a trade-by-trade basis, it may in actuality increase risk. It will disallow banking entities to continue to effectively hedge, thus limiting activity with funds and keeping the risk in the marketplace, but at the fund level, thereby exposing individual investors to this unhedged risk. Similarly, program risk trading, in which banking entities manage their risk across the entire trading organization, enables asset managers to swiftly and

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[21] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,875.

[22] *Id. at* 68,874.

[23] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Securities and Exchange Commission Chairman Mary Schapiro).

[24] Indeed, House Financial Services Committee Chairman Spencer Bachus noted that he shared similar concerns, stating that although Chairman Schapiro says the SEC will not look at individual trades, he "doesn't know how you enforce a rule without looking at individual trades." *See id.*

efficiently trade multiple securities in a single transaction. It also allows asset managers to manage significant flows into and out of funds and accounts in a cost-efficient manner. Program risk trading would be significantly impaired if the proposed restrictive interpretation of hedging and trading units were adopted under the Proposed Rule. The result would be significantly reduced ability for funds and accounts to trade with banking entities and diminished market liquidity, as the elimination or substantial reduction of program risk trading would likely result in less trading in general.

D. Municipal Bond Market Exemption

Section __.6(a) of the Proposed Rule describes the government obligations in which a banking entity may trade, notwithstanding the prohibition on proprietary trading, including government obligations and U.S. State and municipal obligations.[25] This exemption is too narrow because it prohibits banks from trading in a significant portion of the current municipal bond activities, including securities issued by State agencies or instrumentalities. We respectfully disagree with the Agencies' interpretation that its exemption is "consistent with the statutory language," because it does not extend the government obligations exemption to include "transactions in obligations of an *agency* of any State or political subdivision thereof."[26]

Further, the Association disagrees with the Agencies interpretation that statutory silence on State agencies is reason to not include State agency transactions within the exemption. Such an interpretation is inconsistent with legislative history. Congress did not intend to limit the funding availability for projects such as hospitals, affordable housing developments, airports, and universities that receive financing through municipal obligations, and in fact, the Dodd-Frank Act specifically permits trading with regard to "obligations of any State or of any political subdivision thereof."[27] Consistent with exercising its sovereign powers through agencies and other instrumentalities, States may authorize political subdivisions to finance a revenue-generating project through the issuance of municipal bonds backed by bond revenues, not taxes. Particularly since the same type of entity may have differing powers from State to State, it is simply unworkable for the Agencies to construct such a narrow interpretation of this exemption.

If the Proposed Rule is implemented as currently drafted, it may have a significant impact on the municipal bond market, affecting not only institutional investors that regularly invest in these markets, but also the States and municipal agencies that will no longer have access to the capital provided by such investors. The municipal markets provide valuable tax-exempt tools for institutional investors. Despite the challenges that municipal issuers face in the current economy, municipal securities continue to have a lower risk of default than other types of debt and are also beneficial to States and municipalities.[28] The result of the Volcker Rule may be the creation of an

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[25] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,877.

[26] *Id. at* 68,878 n.165 (emphasis in original).

[27] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376, 1624 (2010).

[28] "In comparing the riskiness of municipal and corporate bonds, at least in terms of expected default, municipal bonds can be considered much safer than equally rated corporate bonds. According to the rating agency Moody's, there have been only 54 defaults by municipal bond issuers since 1970. Research firm Robini Global Economics estimates the size of the U.S. municipal bond market to be $2.7 trillion. On the other hand, there were 191 defaults by corporate bond issuers in 2009 alone. According the Fitch, the size of the US corporate bond market is about $4 trillion." Stephen J.

unnecessary bifurcation of the municipal securities market, which will impede the ability of tax-exempt organizations to raise capital and negatively affect the liquidity of the municipal markets.

Therefore, the Association urges the Agencies to expand its exemption for proprietary trading in State or municipal agency obligations under Section 13(d)(1)(J) of the BHC.[29] This could be accomplished by adopting the definition of "municipal securities" already included in Section 3(a)(29) of the Securities Exchange Act of 1934. Utilizing such a definition in the exemption would promote the financial stability of the U.S., providing a clearer line for banks to follow on what is covered under the municipal bond market exemption and permitting investors to continue investing in municipal debt at reasonable costs.

II. COVERED FUNDS

Section __.10(a) of the Proposed Rule implements Section 13(a)(1)(B) of the BHC Act and prohibits a banking entity from, as principal, directly or indirectly acquiring or retaining an equity, partnership, or other ownership interest in, or acting as sponsor to, a covered fund, unless certain exemption criteria are met.[30] The covered fund restrictions create a competitive disadvantage for asset managers that are affiliated with banking institutions.

A. Definition of "Covered Fund" and Applicability to Covered Foreign Funds

Although we recognize the Agencies need to address the potential for evasion from the Volcker Rule by capturing certain foreign funds and commodity pools, the approach taken is over-inclusive and should be refined. Currently, the Proposed Rule defines "covered fund" as including both hedge funds and private equity funds.[31] It also covers other funds that are not commonly understood to be either a "hedge fund" or a "private equity fund" by including issuers that are investment companies, as defined in the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of the Act.[32] The "covered fund" definition includes an issuer organized or offered outside of the U.S. which would be a 3(c)(1) or 3(c)(7) fund if offered or organized inside the United States. Sections 3(c)(1) and 3(c)(7) are exclusions from the definition of "investment company" that are commonly relied on by a wide variety of entities that would otherwise be covered by the broad definition of "investment company."

Additionally, the Proposed Rule incorporates the statutory application of the rule to cover "such similar funds as the Agencies may determine by rule as provided in Section 13(b)(2) of the BHC Act."[33] Under this power, the Agencies propose to include commodity pools, as well as the foreign

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Huxley, Ph.D. and Brent Burns, SAFETY OF INVESTMENT GRADE BONDS: EXAMINING CREDIT RATINGS AND DEFAULT RATES OF MUNICIPAL AND CORPORATE BONDS 5 (Asset Dedication 2011).

[29] 12 U.S.C. § 1851(d)(1)(J) (2006).

[30] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,896.

[31] *Id. at* 68,897.

[32] *Id.*

[33] *Id.*

equivalent of any entity identified as a "covered fund."[34] According to the Agencies, these entities are included because they are generally managed and structured similar to a covered fund except that they are generally not subject to the Federal securities laws due to the instruments in which they invest or because they are not organized in the U.S. or one or more States.[35]

Many asset managers operate funds outside of the U.S. that are registered and regulated in those foreign jurisdictions. The Proposed Rule is over-inclusive because it covers all such funds without actually identifying the characteristics that make such funds problematic for U.S. banks, or demonstrating that these funds lack adequate regulation by foreign jurisdictions. Such foreign funds are different from traditional hedge funds or private equity funds, and the Association suggests that the Agencies exclude from the Proposed Rules restrictions on funds that do not present the risks that the Volcker Rule is intended to address. We propose a number of suggested changes to this end:

- As the scope of the Volcker Rule restrictions is intended to be limited to funds with U.S. resident investors, the Agencies should consider simply excluding all foreign funds that are not actively marketed to U.S. investors. This would have the additional benefit of clarifying that inadvertent sales of interests in foreign funds to persons who are or who become U.S. residents would not subject the fund to the restrictions of the Volcker Rule.

- The Agencies should further consider excluding non-U.S. regulated funds, such as UCITS funds and other European regulated funds, that are subject to a degree of supervisory regulation in foreign jurisdictions that make it unlikely that they would pose significant risk to a banking entity or the United States.

- In the alternative, we urge the Agencies to focus on specific characteristics rather than attempting to cover all foreign funds. The Agencies should consider adopting an exemption from the definition of covered funds using a system based on the characteristics suggested in Form PF. Form PF requires reporting of certain information by advisers to hedge funds and private equity groups. It focuses on these funds because they possess the type of risky trading strategies that typically concern regulators, which are also at the heart of the Volcker Rule prohibitions. Form PF also excludes funds that pose minimal systemic risk, while the Volcker Rule has no such exemptions. For example, State-registered advisers and "Exempt Reporting Advisers" are exempt from having to file Form PF with the SEC because they pose minimal systemic risk. Therefore, we suggest the Agencies consider covering only foreign funds, which exhibit several of the following attributes: (1) engaging in significant leverage; (2) having significant investment in derivatives and illiquid instruments; (3) not providing frequent liquidity rights of investors; and (4) incentivizing managers to engage in risky investments or techniques through performance fees.

This scope should also be applied to covered funds and private equity funds in both the U.S. and foreign markets to create a logical and consistent approach for the Agencies to address the core aspects of the Volcker Rule, which is to reduce systemic risk without violating important market

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[34] *Id.*

[35] *Id.*

functions. By establishing such a system, the Agencies would be excluding foreign funds regulated similarly to mutual funds and bank common and collective funds. This would exclude funds offered to retail investors that are substantively regulated, such as UCITS funds, where less risk exists.

The Proposed Rule's extension to "commodity pools" may now include 40 Act Funds. Narrowing the commodity pool scope to exclude those funds that invested in commodities for hedging purposes and otherwise cover their exposure consistent with SEC Release IC-10666 and related no-action letters is a prudent approach. Under SEC Release IC-10666 the SEC typically allows investments in commodities and derivatives among other financial instruments so long as assets are segregated from core exposure and are in amounts sufficient to cover all of the hypothetical borrowing.[36]

Finally, the "covered funds" definition should be amended to exclude wholly owned subsidiaries, rather than exempting only those engaged in liquidity management. Since the definition of covered funds is so expansive it will cover wholly owned subsidiaries engaged in non-risky, permissible activity which was to be protected and ultimately hinder the ordinary course of business for holding companies.

B. Exemptions

Section __.11 of the Proposed Rule sets out the conditions that must be met in order for a banking entity to own an interest in a covered fund.[37] These conditions include: (i) the banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services; (ii) the covered fund must be organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity; (iii) the banking entity may not acquire or retain an ownership interest in the covered fund except as permitted under the Proposed Rule; (iv) the banking entity must comply with the restrictions governing relationships with covered funds under the Proposed Rule; (v) the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (vi) the covered fund, for corporate, marketing, promotional, or other purposes, (A) may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof), and (B) may not use the word "bank" in its name; (vii) no director or employee of the banking entity may take or retain an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund; and (viii) the banking entity must (A) clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents) the enumerated disclosures contained in the Proposed Rule, and (B) comply with any additional rules of the appropriate Agency or Agencies, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity.[38] While the Association agrees

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[36] Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25,128 (Apr. 27, 1979).

[37] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,900.

[38] *Id.*

with some provisions included in these exemptions, including the bona fide services provisions and the provisions on investments by employees and directors providing advisory or other services, we have concerns with the naming prohibition.

1. Bona Fide Services

The Association fully supports the bona fide services provisions included under Section __.11(a) of the Proposed Rule. The Association agrees that entities must have the ability to provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to customers and supports the Agency's conclusion that the customer's relationship does not need to be pre-existing. When a bank is engaging in such bona fide services, the goal is to support the customer's needs, not to engage in risky behavior. Further, this exemption avoids a potential conflict of interest for asset managers that are affiliated with banks and may otherwise have difficulty continuing to provide advisory services to their clients without changing their business model.

2. Naming Prohibition

Section ___.11(f) of the Proposed Rule provides that the covered fund, for corporate, marketing, promotional, or other purposes, (1) may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof), and (2) may not use the word "bank" in its name.[39]

We believe the naming prohibition proposal over-reaches, and we urge the Agencies to interpret the congressional mandate as narrowly as possible. We note that at present, the Proposed Rule's language expands beyond the Dodd-Frank Act, which amends the BHC Act to include that a banking entity may not share with the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[40] The Dodd-Frank Act does not require the Agencies' rulemaking to preclude the use of the name of investment management firms affiliated with banking institutions, and we therefore urge the Agencies to limit the definition of "banking entity" in this context to U.S.-insured depository institutions.

As the Proposed Rule currently stands, the naming prohibition burdens the industry without providing adequate corresponding benefits. Under Section ___.11, the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests.[41] This restriction is sufficient for ensuring that the entities are viewed separately in the market. We question the necessity for any naming prohibition when a prohibition on bailing out funds is in place and where there is disclosure that investors bear the risk of loss in any default. The prohibition on bailing out funds protects against the "too big to fail" problems of the financial crisis and the disclosure requirements provide the necessary warning to investors of the risks involved. Further restricting the name of the fund, and in particular restricting the name of the fund beyond the name of the U.S.-insured depository institution, does not provide sufficient additional benefits.

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[39] *Id. at* 68,902.

[40] *Id.*

[41] *Id. at* 68,901.

It will be burdensome and expensive for funds currently affiliated with banks or bank-owned asset managers to change the name of the fund. Not only will the process be costly, but potential reputational costs also exist, as many of these funds have developed a solid reputation and good will within the marketplace that is affiliated with the fund's current name. Such actions will also inevitably lead to investor confusion, as many already associate certain fund names in the marketplace with certain characteristics. Ultimately, this restriction will place these funds affiliated with banking entities at a disadvantage and further hurt the financial condition of such funds and their bank-affiliated asset managers.

3. Investments by Employees and Directors Providing Advisory or Other Services

Section ___.11(g) of the Proposed Rule implements Section 13(d)(1)(G)(vii) of the BHC.[42] The provision prohibits any director or employee of the banking entity from acquiring or retaining an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund.[43] The Association generally supports the Agencies' approach and agrees it is essential that fund managers or advisers and support staff be permitted to have, "skin in the game." Indeed, many institutional investor clients require this as an additional check on the fund manager's or adviser's loyalty and diligence.

The Proposed Rule also recognizes that director or employee investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire or retain in a covered fund or funds contained in Section 13(d)(4) of the BHC Act and Section 1.12 of the Proposed Rule.[44] To address this concern, the Proposed Rule would generally attribute an ownership interest in a covered fund acquired or retained by a director or employee to such person's employing banking entity, if the banking entity either extends credit for the purpose of allowing the director or employee to acquire such ownership interest, guarantees the director or employee's purchase, or guarantees the director or employee against loss on the investment.[45] Once again, the Association agrees that this solution adequately addresses the problem while still permitting such employees the ability to meet client needs.

C. Sections 23A and 23B of the Federal Reserve Act

The Dodd-Frank Act mandates additional restrictions on transactions between affiliates, amending Section 13(f)(1) of the BHC Act to generally prohibit a banking entity that, directly or indirectly, serves as an investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund from engaging in any transaction with a covered fund if the transaction would be a "covered transaction" as defined in Section 23A of the Federal Reserve (FR) Act, as if the banking

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[42] *Id. at* 68,902.

[43] *Id.*

[44] *Id.*

[45] *Id.*

entity and any affiliate thereof were a member bank and the covered fund were an affiliate thereof.[46] Section 23A and Regulation W limit the aggregate amount of "covered transactions" between a bank and any single affiliate to 10 percent of the bank's capital stock and surplus, and limit the aggregate amount of covered transactions with all affiliates to 20 percent of the bank's capital stock and surplus.[47] A "covered transaction" under 23A includes, for example, the extension of credit by a bank to an affiliate and the issuance by a bank of a guarantee on behalf of an affiliate.[48]

Section __.16 of the Proposed Rule, consistent with the Dodd-Frank Act requirements, is more restrictive than Section 23A. Section __.16 generally prohibits a banking entity and any of its affiliates from entering into any such transaction, while Section 23A permits covered transactions with affiliates so long as the transactions meet certain requirements.[49] Essentially, the Proposed Rule would prohibit all entities in a banking organization, and not merely the "bank," that act as an investment adviser or sponsor to a covered fund from engaging in certain transactions, including providing loans to or investments in a covered fund. Unfortunately, the Proposed Rule does not recognize certain standard exemptions available under Section 23A and Regulation W, whereby certain activities are recognized to not inhibit the goals of safety and soundness and allow for a functioning market to continue.

Under the additional restrictions provided for in the Proposed Rule, banks and their affiliates would not be able to engage in limited types of covered transactions currently permitted by the exclusions and restrictions under Section 23A when lending to affiliates. Unlike the regulations between banks and their affiliates, where limitations exist but banks are still able to lend, the Proposed Rule would make it so that advisers are no longer permitted to lend money to funds in the same way as is available for banks to lend to operating affiliates. In practice, this provision would allow banks to engage in more extensive activities with affiliated and unaffiliated entities than would be permitted between a bank or its affiliate and an affiliated hedge fund, creating an unequal playing field for affiliated funds and potentially increasing interconnectedness amongst major banks.

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[46] Under Section 23A a member bank and its subsidiaries may engage in a covered transaction with an affiliate only if: (A) in the case of any affiliate, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 10 per centum of the capital stock and surplus of the member bank; and (B) in the case of all affiliates, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 20 per centum of the capital stock and surplus of the member bank. *See* 12 U.S.C. § 371c(a) (2006).

[47] 12 U.S.C. § 371c(a)(1) (2006); 12 CFR §§ 223.11, 223.12 (2012).

[48] 12 U.S.C. § 371(b)(7) (2006); 12 CFR § 223.3(h) (2012).

[49] For reference, under Section 23B of the FR Act a member bank and its subsidiaries may engage in: (A) Any covered transaction with an affiliate; (B)The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase; (C) The payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise; (D) Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; or (E) Any transaction or series of transactions with a third party if an affiliate has a financial interest in the third party, or if an affiliate is a participant in such transaction or series of transactions, only in certain circumstances. A member bank and its subsidiary may engage in these activities only: (1) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies; or (2) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies. *See* 12 U.S.C. § 371c–1 (2006).

The Association also questions the necessity to restrict activity more tightly between banks and affiliates when the banks are engaged in the traditional functions of custodian banks. Custodian banks that also manage covered funds must be able to continue to provide custodian services, such as providing intraday credit in connection with routine security and currency deliveries of payment transactions. While the Association acknowledges that lines of credit may create potentially risky situations, provisional liquidity services in connection with payment transactions merely facilitate the trade and ensure that delays caused by unavoidable situations, such as currency issues, do not derail the trade. Custodian banks need to continue this activity to provide at least some straight-thru processing for their managed funds. If custodian banks are unable to provide custodian services, more risk would be introduced into the settlement process, because funds would have to find third party custodians or others to offer intraday credit to provide the necessary liquidity. Turning to third parties for such intraday credit may create operational challenges and disrupt the settlement process without providing any benefit to the market or end investor. It would also increase risk to the banking organization and markets without providing corresponding benefit, as the bank may still perform the same role and engage in the same types of activities with unaffiliated funds.

D. Limitations on Fund Investments

Section __.12 of the Proposed Rule describes one of the limited circumstances under which a banking entity may acquire or retain, as an investment, an ownership interest in a covered fund that the banking entity or its affiliates offer.[50] Banking entities may take an ownership interest in a covered fund if the banking entity's investment is limited to no more than three percent of the total outstanding ownership interests of such fund (after the expiration of any seeding period provided under the rule).[51] The Proposed Rule also requires that the banking entity's investment in a covered fund may not result in more than three percent of the losses of the covered fund being allocable to the banking entity's investment.[52] Further, the banking entity may not invest more than three percent of its Tier 1 capital in covered funds in the aggregate.[53]

The Association believes this restriction will be harmful to bank-owned asset managers, by both eliminating the ability of these managers to launch non-40 Act Funds and also limiting the ability of bank-owned managers to launch innovative strategies that address the needs of institutional clients, such as large pension funds, if the fund may not meet all of the requirements of 40 Act Funds. This would harm investors generally, as well as bank-owned asset managers.

Typically, bank asset managers will market affiliated funds that have at least a three-year performance record in order to attract institutional investors. In order to create such a longstanding record, the manager will typically seed a strategy for the initial three years with capital. Few asset managers or investors are willing to invest in a strategy that does not have a three-year performance record. Because of the broad application of the Volcker Rule to bank-affiliated managers, the three percent restriction will severely curtail a bank-affiliated manager from investing its own money to

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[50] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,903.

[51] *Id.*

[52] *Id.*

[53] *Id.*

create the three-year performance record, and effectively eliminate an advisor's ability to launch new strategies that are not 40 Act Funds.

We acknowledge that the Agencies must adhere to the statutorily mandated restriction which includes a one-year time limit. However, we encourage the Agencies to implement a system whereby an additional two-year extension is available upon request for incubation of new and innovative products, as this would be "consistent with safety and soundness and in the public interest," particularly where separate capital of the manager is used and the fund does not utilize capital from the insured depository institution.[54] We worry that the factors required under the final rule on the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities create too high of a hurdle to meet, or at a minimum, create uncertainty as to whether a bank will qualify for the extension.[55] Rather than requiring an entity to essentially extinguish all other options, we argue an additional two years should be presumed to be granted in situations where a bank can establish that its actions are part of a legitimate product development program.

III. AGENCY COORDINATION

The Association also is concerned that the Agencies have not adequately clarified which Agency will be responsible for ensuring compliance with various components of the Proposed Rule. We worry that without the proper coordination, entities will be subjected to overlapping and potentially inconsistent regulation. Beyond wanting to ensure that our member firms fully understand how to comply with the final regulations, when issued, it would also be helpful to ensure that there is no disconnect between the Agencies that could translate into the same regulations being interpreted differently by different Agencies. Many of our members are regulated by more than one of the Agencies. For example, both the SEC and bank regulatory authorities regulate our members that are affiliated with banks. The Association requests that the final rulemaking articulate that the Agencies will coordinate oversight efforts and clarify which agency will supervise in various situations.

IV. DELAY OF IMPLEMENTATION

The Association agrees with House Financial Services Oversight and Investigations Subcommittee Chairman Randy Neugebauer (R-TX) and the other House Financial Services Committee Members who urged the Agencies in a December 20, 2011, letter to consider comments to the Proposed Rule and then issue an interim final rule reflecting comments from affected stakeholders.[56] We commend the Agencies for including numerous questions and making public statements on their willingness to consider industry concerns with the Proposed Rule, and would appreciate the opportunity to further comment before the rulemaking is final. Further, although we understand that it may take

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[54] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

[55] Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8,265 (Feb. 14, 2011).

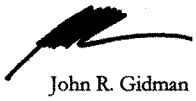
[56] Letter from Rep. Randy Neugebauer to Chairman Ben Bernanke, Fed. Reserve Bd., Chairman Gary Gensler, Commodity Futures Trading Comm'n, Acting Comptroller of the Currency John Walsh, Office of the Comptroller of the Currency, Chairman Mary Schapiro, Sec. and Exch. Comm'n, and Acting Chairman Martin Gruenberg, Fed. Deposit Insurance Corp. (Dec. 20, 2011), *available at* http://randy.house.gov/uploads/Neugebauer%20House%20Volcker%20Rule%20Ltr1.pdf.

congressional action to delay implementation of the final rule (as Section 619 becomes effective on July 21, 2012, even without a final rule), we note that there have been other situations where statutory deadlines were missed because of the complexity or challenges faced by the Agencies in implementing rules within the time frame established by Congress.[57] Therefore, we urge the Agencies to delay the time for compliance with this deadline in view of the many unsettled questions and issues they raise and the need for the industry to have final guidance before making significant investment of time and resources to modify their operations. It is important to ensure that regulators have the time necessary to re-propose the rulemaking, and market participants need time to adjust activities to comply with the final rulemaking. Although we recognize that covered banking entities have a two-year conformance period to bring existing activities and investments into compliance with Section 619 of the Dodd-Frank Act, we argue this does not adequately replace providing the Agencies with enough time to consider market concerns without worrying about an arbitrary deadline.

V. CONCLUSION

The Association recognizes the challenges the Agencies face in implementing these new requirements and appreciates the Agencies considering our concerns. We thank the Agencies for the opportunity to comment on the Proposed Rule. Please feel free to contact me with any questions you may have on our comments at jgidman@loomissayles.com or (617) 748-1748.

On behalf of the Association of Institutional INVESTORS,



John R. Gidman

[57] As of February 1, 2012, a total of 225 Dodd-Frank rulemaking requirement deadlines have passed. More than half of these deadlines have been missed. For example, last July the SEC and CFTC announced that they would miss deadlines on derivatives rulemakings and suspend some new derivatives rules so that the Commission had time to consider what if any further action was required. Press Release, Securities and Exchange Commission, SEC Proposes Exemptions from Registration Requirements for Security-Based Swaps Issued by Certain Clearing Agencies (June 10, 2011), *available at* http://www.sec.gov/news/press/2011/2011-124.htm.

100 Years Standing Up for American Enterprise

U.S. CHAMBER OF COMMERCE

Statement of the U.S. Chamber of Commerce

ON: "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Part II"

TO: The House Committee on Financial Services

DATE: December 13, 2012

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Chairman Bachus, Ranking Member Frank and members of the House Financial Services Committee. My name is Tom Quaadman, Vice President for the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce. The Chamber is the world's largest business federation representing the interests of more than three million businesses and organizations of every size, sector and region. On behalf of the Chamber's membership, I appreciate the opportunity to testify on the impacts of the Volcker Rule upon markets, businesses, investors and job creation.

America's businesses, in order to compete, grow and create jobs, need efficient capital markets. Efficient capital markets allow businesses to have the access to the resources needed to operate on a daily basis and strategically plan for long-term success. They give businesses large and small the means and confidence to plan, expand and create jobs. Effective regulators who understand these markets allow good actors to play on an even playing field while driving out bad actors and punishing them.

There is a direct link between the strength and resiliency of the American economy and the fact that our capital markets are the deepest, broadest and most resilient in the world.

While the intention of the Volcker Rule is to ban "proprietary trading" by financial institutions, the reality of the Volcker Rule is that it creates an ill-defined and ill-conceived standard that will impair the efficiency of American capital markets in a way that will harm businesses and investors who rely on those markets.

The Chamber supports policies that will improve the efficiency of the capital markets and prevent another financial crisis. We do not believe that the Volcker Rule meets those goals. This is why the Chamber has supported higher capital requirements, instead of a unilateral ban on proprietary trading, as a pro-growth means of stabilizing the financial system.

The Volcker Rule, as proposed, will not promote growth or stabilize the financial system. Indeed it will make U.S. capital markets less robust, U.S. businesses less competitive and ultimately hamper economic growth and the job creation that accompanies it. The lack of clarity in the proposed regulatory provisions and the vagueness of the term "proprietary trading" itself will cause financial institutions to scale back and even cease to offer some critical services they provide, reducing capital formation for non-financial businesses.

Mr. Chairman, the Chamber is very appreciative of the letter that you and Representative Hensarling sent requesting a further delay in the completion of the

Volcker Rule. The Chamber also supports the introduction of H.R. 6524. This bill was introduced by Rep. Peter King, to stay enforcement of the Volcker Rule until other nations adopt similar restrictions. These efforts are important steps to preserve American competitiveness.

Cumulative Impacts of the Volcker Rule and other Regulatory Initiatives

The Volcker Rule cannot be viewed in a vacuum and must be examined in light of other major financial regulatory initiatives including potential new money market fund regulations, derivatives regulations and Basel III capital standards. Each has been proposed to address a perceived need to change a different segment of the financial system.

However, each of these regulatory initiatives has unique and collective impacts upon the ability of a corporate treasurer to make sure that a business has the cash to pay the bills and grow:

- The Volcker Rule impacts the ability of businesses to access the debt and equity markets.
- New money market proposals affect the capacity of a business to sell commercial paper and use efficient cash management techniques.
- Derivatives regulations shape the ability of businesses to manage risk and lock in prices for raw materials.
- Basel III impinges on the ability of businesses to access commercial lines of credit and obtain bank loans.

Each will impact treasury operations of American businesses and the cumulative impact of these efforts could be devastating.

Companies doing business in the U.S. operate with approximately $2 trillion of cash reserves, which is a historically high number. That number represents 14% of U.S. gross domestic product, but in contrast, corporate cash reserves in the Euro zone is 21% of Euro zone GDP.

Highly liquid capital markets in the United States permit treasurers to keep less cash on hand and use a "just-in-time" financing system that allows companies to meet working capital needs and raise additional capital needed to expand and create jobs.

Should the Volcker Rule be enacted in its present form, capital efficiency will decline, resulting in the need to maintain increased corporate cash buffers. Were idle cash reserves to rise to the Euro zone level of 21% of GDP, that new level would be $3 trillion. Higher cash reserves would not be an historic outlier; it will be the new normal.

Stated differently, corporate Treasurers would need to set aside and idle an additional $1 trillion of cash. This would seriously slow the economy to the detriment of businesses and consumers alike. To raise this extra $1 trillion cash buffer, companies may have to downsize and lay off workers, reduce inventories, postpone expansion and defer capital investment. Obviously, the economic consequences would be huge if U.S. companies had to withdraw from productive use funding that dwarfs the stimulus bill.

Specific Concerns with the Volcker Rule

The ambiguity surrounding provisions of the Volcker Rule is likely to have a chilling effect on precisely those banking services that account for U.S. competitiveness, capital efficiency and financial stability. This is an issue for U.S. businesses, large and small.

Some of the unintended consequences of the Volcker Rule include:

- Impaired market liquidity and reduced access to credit
- Higher costs and less certainty for borrowers
- Restricted trading in proper and allowable businesses
- Competitive disadvantage for U.S. businesses and financial institutions
- Prohibitions on traditional investments mislabeled as "funds"
- Increased compliance costs for **non-financial** businesses
- Higher bank fees for consumers and businesses
- Less access to capital for small business and start ups

- Shifting of risks to other sectors of the economy
- Capital flows into offshore markets
- Potential Trade Violations
- Extension to joint ventures

a. Impaired market liquidity and reduced access to credit

The Volcker Rule may impair the ability of banks to function as market makers. Banks act as significant buyers and sellers of securities to ensure that borrowers can find investors and investors can find investments.

As market makers, banks hold inventory. This could be inventory in various investment instruments, Treasury debt, customer securities and foreign currencies. However, the Volcker Rule will significantly constrain market making by dictating how banks should manage their inventory. This will reduce the depth and liquidity of our capital markets.

For example, corporations, municipalities, healthcare providers and universities rely upon the "market making" activities of bank in order to secure affordable funding in the bond market. Bank trading activities are what create market liquidity and enable the market to provide an efficient clearing price. Thus, if banks can no longer hold inventory, it will be much more difficult for businesses, municipalities and schools to raise capital.

Without these activities, markets could take a giant step backward. Many American businesses will have to rely solely on commercial loans. This will increase their financing costs and force them to hold greater idle cash reserves.

b. Higher costs and less certainty for borrowers

The Volcker Rule will increase the cost of capital for all companies. With reduced market liquidity, transaction spreads widen, risks increase and price changes become more volatile. To compensate for these new risks, investors will demand higher rates.

Because banks can currently underwrite a bond issue for a customer and hold any unsold bonds in inventory, credit worthy borrowers can be reasonably assured of timely access to credit. However, under the Volcker Rule in its current form, banks may not be able to hold that inventory. They therefore, may decide to defer or delay underwriting those bonds for their customers until buyers are found in advance.

Imagine a municipality or a hospital facing a critical funding need. Under the Volcker rule, they may go bankrupt waiting for a bank to line up the funding. Or, they would end up paying a crippling rate.

c. Restricted trading in proper and allowable businesses

The Proposed Rule is inherently complicated and forces regulators to discern the intent of a trade. Worse, they require banks to "prove" the intent of each trade. This cannot be done in any reliable and consistent way. One entity's proprietary trade is another entity's market making activity—the trades may look no different on paper. 'Proprietary trading' defies a symmetrical definition.

The complexity and vagueness of the Volcker Rule will force banks to adopt the most conservative interpretation of the rule and err on the side of prohibiting certain trades that have no proprietary "intent". With the burden of proof on the banks, the compliance costs become prohibitive. The net result will likely be the elimination of perfectly acceptable "market making' activities. This could result in banks exiting or scaling back such routine activities as commercial paper issuance, cash management sweep accounts and multi-currency trade finance.

d. Competitive disadvantage for U.S. businesses and financial institutions

The United States' major trading partners have rejected the Obama Administration's request to follow the Volcker Rule. This puts American businesses and financial institutions at a disadvantage. By eliminating a core revenue stream from U.S. banks, the Volcker Rule would effectively reduce the ability for U.S. banks to compete and continue to provide services that are essential to our nation's businesses. Additionally, in order to avoid the territorial jurisdiction of the Volcker Rule, foreign financial firms may retreat from the U.S., further depriving American businesses of capital and degrading the ability of U.S. regulators to oversee and regulate financial activity.

Finally, most companies will still have financial risks that need to be managed. U.S. business will increasingly turn to foreign banks in overseas markets to serve this

function. Perversely, this will simultaneously weaken U.S. banks while strengthening foreign banks.

e. Prohibitions on traditional investments mislabeled as "funds"

There has been wide recognition by the Financial Stability Oversight Council and industry members that the Volcker Rule's definitions of private equity funds and hedge funds are extremely overbroad, and could result in unintended prohibitions of legitimate and useful activities and investments. Unless corrected through regulation or legislation, this over-breadth could prohibit securitization vehicles, cash management entities, certain joint ventures and even internal holding companies simply because they meet a technical legal standard that is common among true investment funds.

Prohibiting these investments would severely disrupt all businesses affected by the Volcker Rule, and would have ripple effects throughout the real economy as legitimate business activities such as securitization, cash management and joint venture business partnerships are disrupted.

f. Increased compliance costs for *non-financial* businesses

The reach of the Volcker Rule can extend to non-financial businesses, although they present no systemic risk whatsoever. Many businesses offer financing services to their customers to accommodate their commercial relationship. They may own a depository institution, have a commercial or consumer finance subsidiary or sponsor a credit card. These businesses will incur increased costs and higher compliance burdens. Some will pass these costs on to their customers. Others will simply discontinue these financial services. In any event, the result is higher cost credit for those willing to pay and less credit for most small businesses and consumers.

g. Higher bank fees for consumers and businesses

The cumulative effect of regulatory changes such as the Volcker Rule, and Basel III will be to reduce or eliminate core banking revenue. At the same time, the Volcker rule will materially increase the costs of regulatory compliance. In order to continue providing high quality technologically advanced banking services, U.S. banks will need to increase banking fees on a wide range of services. They may also need to become more selective in the customer segments they choose to serve, thereby reducing the general availability of banking services.

h. Less access to capital for small business and start ups

As banks restrict the availability of their services and increase the price, an inevitable "crowding out" will occur. The largest corporations and those who transact in the highest denominations will still have access to credit and risk management products. However, the less credit worthy customers and start-ups will be left out. Many traditional services will be no longer cost effective. Some may not be available to those segments at all.

i. Shifting of risks to other sectors of the economy

In the dynamic world of free enterprise, risk is neither created nor destroyed. It can only be transformed. A corporate CFO whose company imports a raw material from the Far East, for example, must manage currency risk, commodity price risk, interest rate risk and operational shipping risks. Simply precluding a bank from helping the company hedge those risks, the Volcker Rule does not make those risks go away.

CFOs and Treasurers will undoubtedly conclude that some risk management techniques and some heretofore efficient transactions will no longer be cost effective. They will decide to "go naked" and retain that risk internally. The upshot of this is that they will hold even more precautionary cash on their balance sheets as a buffer. This will take money out of the real economy.

j. Capital flows into offshore markets

Corporate treasury is the financial nerve center of a company, daily facing and managing the complexities of the global markets. Most treasurers select a lead bank as their primary source of capital, information and advice. That bank must be one that cannot only give the company global visibility, but can seamlessly operate in markets far and wide. The Volcker Rule would virtually eliminate U.S. banks from contention for that important 'lead' role.

Many U.S. multinational companies are already selecting lead banks for each region of the globe, eroding the dominance of the U.S. banks. Many companies are establishing regional treasury centers for functions traditionally housed in the U.S. All of this leads to capital flowing out of the U.S. and competitiveness declining.

k. Potential Trade Violations

Many nations including Canada, Japan, the United Kingdom, and Singapore have objected to the Volcker Rule, citing adverse consequences to *their* ability to issue

sovereign debt. The Volcker Rule is discriminatory, as foreign sovereign debt is subject to the regulation, while U.S. Treasury debt instruments are exempt. This creates a discord in the G20 and invites foreign governments to retaliate at a time when we need those same regulators in foreign countries to support initiatives to liberalize trade in financial services. The Chamber has called for the U.S. Trade Representative ("USTR") to conduct a very close examination to ensure the Volcker Rule does not violate any of our trade obligations. Ultimately it may not, but the Volcker Rule's discriminatory provision certainly does, at a minimum, send the wrong message internationally and gravely complicates the long-standing U.S. goal of liberalizing trade in financial services in addition to creating a potential problem for U.S. sovereign debt if foreign governments decide to retaliate.

The Chamber believes it is important that USTR evaluate the Volcker Rule in the context of our trade commitments and be an active voice in the inter-agency process so that regulators understand the costs to the American economy and potential retaliatory actions the United States faces if other nations treat the Volcker Rule as a trade violation or choose to adopt similar restrictions on U.S. sovereign debt.

1. **Extension to Joint Ventures**

Joint Ventures are a means of companies and entities to band together and equally develop new business lines or assets. This is an important vehicle for companies to remain competitive, particularly overseas where partnership with a local business may be necessary to enter the market. Under the Volcker Rule, if an entity involved in a Joint Venture is deemed to be part of a "banking entity" and required to have a Volcker Rule compliance program, then the Joint Venture itself would also be required to have a Volcker Rule compliance program and face all of the associated activity limitations under the Rule. This is an illogical overextension of the Volcker Rule. Subjecting Joint Ventures to Volcker Rule prohibitions and compliance programs will increase regulatory complexity for Joint Ventures and place American companies at a competitive disadvantage as compared to their foreign counterparts.

Process Concerns with the Volcker Rule

The Volcker Rule, first proposed in 2011, encompasses 298 pages and asks over 1,000 questions. This is an extremely complex regulation that could lead to oversight of the issuance and trading of bonds and stocks on an unprecedented scale. News reports have indicated that 1) regulators are reluctant to re-propose the rule and 2) that the Securities and Exchange Commission and banking regulators may have some significant differences.

We are troubled that there may not be a re-proposal of the Volcker Rule. This will deprive stakeholders of an opportunity to review the final rule and compare it to the proposed rule. Informed commentary of a re-proposal will give regulators important feedback to avoid unintended adverse consequences before the Volcker Rule is finalized. We believe that regulators may be missing an important opportunity to fix a flawed proposal.

The Chamber is also concerned that the Volcker Rule has a fractured, incomplete and uncoordinated study of the economic impacts and costs and benefits associated with the proposed rule. Thus, stakeholders were not provided an analysis of the costs and benefits associated with the proposed rule to provide regulators with informed commentary.

The Volcker Rule Proposal must follow the requirements of the Administrative Procedures Act ("APA"). Additionally, the Federal Reserve, FDIC, OCC, SEC ,and CFTC each have differing legal standards and internal practices they must meet for economic analysis when promulgating a rule. There is a real question as to whether many of these agencies have satisfied these obligations as to the proposed Volcker Rule. Given this haphazard and uncoordinated analysis under existing practices, the Chamber a year ago proposed that all of the agencies involved in the Volcker Rule Proposal establish a common baseline for cost-benefit and economic analysis by using the blueprint established by Executive Orders 13563 and 13579, in addition to other requirements they must follow.[1] This would allow meaningful, cumulative analysis that would result in a more coherent final rule with fewer harmful, unintended consequences for America's capital markets.

Last year, the Chamber provided the regulators with examples of the significant costs to non-financial companies that we believe were not contemplated in the initial Volcker Rule release. The Chamber conducted a survey that uses 2010-2011 historic data of select U.S. financing companies that service non-financial businesses. Based on credible assessments that the Volcker Rule will impose a 5 basis point increase in bid-ask spreads, for just the 5 companies selected, the increased lending costs total nearly $150 million for just those companies. The survey also includes an analysis of switching transactions—the process whereby a financial institution buys back some of an issuer's older bonds as part of the process for a new issuance. A 10 basis point increase caused by the Volcker Rule would increase the costs of switching

[1] Executive Order 13579 requests that independent agencies follow the requirements of Executive Order 13563. Both executive orders were issued by President Barack Obama.

transactions by $2.8 million per billion issued while a 50 basis point increase would drive up costs by nearly $14 million per billion issued.

Because there is ample reason to believe that the costs that would be imposed by the proposed Volcker Rule to the economy, state and local governments are well over $100 million, the OCC should submit the proposed rule to an Office of Information and Regulatory Affairs ("OIRA") regulatory review process. The Federal Reserve, FDIC, SEC and CFTC should also voluntarily submit their portions of the Volcker Rule Proposal for an OIRA regulatory review process to ensure consistent and uniform analysis.

Conclusion

The Chamber continues to have serious concerns that the Volcker Rule, as currently constructed, will not reduce systemic risk nor improve economic well-being. We believe that it will make U.S. capital markets less robust, U.S. business less competitive and ultimately reduce underlying economic activity and the job creation that accompanies it. We believe that the lack of clarity in the proposed rule and definition of "propriety" trading itself will cause financial institutions to scale back and even exit some of the critical services they provide.

I am happy to discuss these issues further and answer any questions you may have.

STATEMENT OF

PAUL SCHOTT STEVENS
PRESIDENT AND CEO
INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ON

"EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES, INVESTORS AND JOB CREATION, PART II"

DECEMBER 13, 2012

EXECUTIVE SUMMARY

- Congress enacted the Volcker Rule to restrict banks from using their own resources to trade for purposes unrelated to serving clients and to address perceived conflicts of interest in certain bank transactions. The Volcker Rule was *not* directed at registered funds. Unfortunately, the regulatory proposal to implement the Volcker Rule ("Proposed Rule") nonetheless raises a number of serious concerns for U.S. mutual funds and other types of registered investment companies ("registered funds").

- Chief among our concerns is the fact that the Proposed Rule could treat many registered funds as hedge funds—a result that contradicts the plain language that Congress passed. Providing an express exclusion for registered funds would avoid this result.

- Similarly, without an express exclusion, it is possible that some registered funds could be treated as "banking entities" and subject to all of the prohibitions and restrictions in the Volcker Rule. It is clear that Congress did not intend such a result, and providing this exclusion for registered funds would in no way thwart the policy goals of the Volcker Rule.

- ICI supports the overall goals of the Volcker Rule's proprietary trading prohibition, particularly the need to address systemic risk concerns surrounding truly speculative proprietary trading. We do not believe, however, that the Proposed Rule's proprietary trading restrictions, as currently drafted, will achieve these goals. Instead, they may adversely impact the financial markets and the ability of registered funds and other investors to participate in the markets.

- We are particularly concerned that the Proposed Rule would decrease liquidity, especially for those markets that rely most on banking entities to act as market makers, such as the fixed income and derivatives markets and the less liquid portions of the equities markets. A reduction of liquidity would have serious implications for registered funds, ultimately leading to the potential for higher costs for fund shareholders.

- The proprietary trading provisions of the Proposed Rule call into question whether banking entities could continue to serve as Authorized Participants ("APs") and market makers for exchange-traded funds ("ETFs"), an increasingly popular form of registered fund that is structured to permit investors to buy and sell shares at market prices throughout the trading day. AP transactions and related ETF market making activity are critical to maintaining efficient pricing in the ETF marketplace and protecting ETF investors. We recommend making it clear that banking entities can continue to fulfill these important roles.

- The Proposed Rule raises similar and additional concerns for the foreign counterparts to registered funds, *i.e.,* funds that are publicly offered and substantively regulated outside of the United States ("non-U.S. retail funds"). Without substantial changes, the Proposed Rule would unduly impede the ability of both U.S. and non-U.S. entities to organize, sponsor, and operate non-U.S. retail

funds and harm certain financial markets, market participants, and financial instruments. Providing an exclusion for non-U.S. retail funds would ensure that the Volcker Rule is not applied more restrictively outside the United States than within, and is consistent with Congressional intent to limit the extraterritorial impact of these requirements.

I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute ("ICI"), the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs").[1] ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of registered funds, their shareholders, directors, and advisers. As of December 2012, members of ICI manage total assets of $13.8 trillion.

I appreciate the opportunity to provide ICI's perspective on the impact of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act—commonly known as the "Volcker Rule"—on markets, businesses, investors, and job creation. The registered fund industry has a unique perspective, because our funds are both issuers of securities and investors in domestic and international financial markets.

As with the Dodd-Frank Act more broadly, ICI has closely followed developments related to the implementation of the Volcker Rule, actively engaging with policymakers during the implementation process. Our efforts are focused on ensuring that the implementing regulations do not have harmful or unintended consequences for registered funds and their shareholders—or for the financial markets or the broader economy—and that any final regulations strike the right balance between costs and benefits.

Congress enacted the Volcker Rule to restrict banks from using their own resources to trade for purposes unrelated to serving clients and to address perceived conflicts of interest in certain bank transactions. As several members of Congress have expressly indicated, the Volcker Rule was *not* directed at registered funds.[2] Unfortunately, the regulatory proposal to implement the Volcker Rule ("Proposed Rule")[3] nonetheless raises a number of serious concerns for the U.S. registered fund

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[1] For ease of reference, this testimony refers to all types of U.S. registered investment companies—including mutual funds, closed-end funds, ETFs, and UITs—as "registered funds," unless the context requires otherwise.

[2] *See, e.g.,* Letter from Reps. Scott Garrett (R-NJ), Shelley Moore Capito (R-WV), Gwen Moore (D-WI) and Gary C. Peters (D-MI) to Agencies, dated May 30, 2012. Similarly, in response to a question at a Congressional oversight hearing, SEC Chairman Mary Schapiro acknowledged that Congress probably did not intend for the Volcker Rule to restrict mutual fund trading and investment activities. Hearing, Capital Markets and Government Sponsored Enterprises Subcommittee, House Financial Services Committee, on "Oversight of the U.S. Securities and Exchange Commission," April 25, 2012.

[3] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (November 7, 2011), issued by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System ("Federal Reserve"), Federal Deposit Insurance Corporation ("FDIC"), and Securities and Exchange Commission ("SEC"). The Commodity Futures Trading Commission ("CFTC") was not a party to the Proposed Rule; instead, it issued a separate yet substantively similar proposal to implement the Volcker Rule. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With,

industry. ICI believes that the Agencies involved have the authority to address most of these concerns through the regulatory process.

If adopted in its original form, the Proposed Rule would reach much farther than it seems Congress intended. For example, the Proposed Rule could treat many registered funds as hedge funds—a result that contradicts the plain language that Congress passed. The Proposed Rule also could restrict banks from acting as market makers buying and selling securities—despite the fact that Congress specifically designated "market making-related activity" as a "permitted activity" for banks under the Volcker Rule. If banks cannot provide these services, particularly in the fixed income and derivatives markets and the less liquid portions of the equity markets, registered funds and other investors likely would face higher transaction costs and diminished returns. The Proposed Rule also could greatly impair the U.S. financial markets by imposing stringent restrictions that go well beyond what is necessary to effectuate Congress' intent in enacting the Volcker Rule, potentially hurting our broader economy and impacting job creation and investments in U.S. businesses overall. Finally, the Proposed Rule, as issued, could limit investment opportunities for registered funds and their shareholders. ICI's comment letter on the Proposed Rule described these and other concerns in detail.[4]

The Proposed Rule raises similar and additional concerns for funds that closely resemble registered funds but are publicly offered and substantively regulated outside of the United States ("non-U.S. retail funds"). Without substantial changes, the Proposed Rule would unduly impede the ability of both U.S. and non-U.S. entities to organize, sponsor, and operate non-U.S. retail funds and harm certain financial markets, market participants, and financial instruments. Our global affiliate, ICI Global ("ICIG"), filed a detailed comment letter addressing the concerns of non-U.S. retail funds.[5]

Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (February 14, 2012). Below, this testimony refers to the foregoing regulators collectively as the "Agencies."

[4] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Ms. Elizabeth M. Murphy, Secretary, SEC, *et al.*, dated February 13, 2012 ("ICI Volcker Comment Letter"), available at http://www.ici.org/pdf/25909.pdf. *See also* Statement of the Investment Company Institute for Hearing on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation," Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (January 18, 2012), available at http://financialservices.house.gov/UploadedFiles/HHRG-112-BA-WState-ICI-20120118.pdf; Statement of Thomas P. Lemke, General Counsel and Executive Vice President, Legg Mason & Co., LLC, on behalf of the Investment Company Institute, before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, on "The Impact of Dodd-Frank on Customers, Credit, and Job Creators" (July 10, 2012), available at http://financialservices.house.gov/uploadedfiles/hhrg-112-ba16-wstate-tlemke-20120710.pdf.

[5] *See* Letter from Dan Waters, Managing Director, ICI Global ("ICIG"), to Ms. Elizabeth M. Murphy, Secretary, SEC, *et al.*, dated February 13, 2012, available at http://www.ici.org/pdf/12_icig_volcker.pdf. ICIG is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICIG seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICIG manage total assets in excess of US $1 trillion.

My testimony highlights important ways in which the Proposed Rule could negatively impact U.S. registered funds and non-U.S. retail funds. After the close of the comment period for the Proposed Rule, Chairman Bachus invited interested parties to submit legislative recommendations for ways to make the Volcker Rule less burdensome. A copy of the proposed legislative changes ICI submitted to Chairman Bachus (revised as of December 12, 2012) is attached as an Appendix to this testimony and several of our recommendations are mentioned herein.

Before turning to those issues, however, I wish to note that some press reports have mentioned the possibility that the individual regulatory agencies charged with implementing the Volcker Rule might adopt final regulations that differ from each other in substance. Such a result, it seems to me, would violate the requirement in Section 619 that the Agencies coordinate their rulemaking so as to

> assur[e], to the extent possible, that such regulations are comparable and provide for consistent application and implementation of this section to avoid providing advantages or imposing disadvantages to the companies affected . . . .

Such a result, moreover, would be particularly unworkable for firms that comprise multiple entities with different primary regulators. We accordingly urge the Committee to do all it can to ensure that any final rules will be consistent across all of the Agencies. Given the significant changes we believe are necessary to address our concerns and those of other commenters, ICI recommended in its comment letter, and still strongly urges, that the Agencies issue a revised proposal for comment before adopting any final rule.

II. ORGANIZATION, SPONSORSHIP AND NORMAL ACTIVITIES OF REGISTERED FUNDS

A. The Volcker Rule Should Not Treat U.S. Registered Funds or Their Non-U.S. Counterparts as Hedge Funds or Private Equity Funds

The Dodd-Frank Act prohibits a banking entity from having an ownership interest in, or acting as sponsor to, a hedge fund or private equity fund. The statute defines "hedge fund" and "private equity fund" as "any issuer that would be an investment company, as defined in the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of that Act," or "such similar funds" as the Agencies may determine by rule—collectively defined in the Proposed Rule as "covered funds."

It is clear that Congress did not intend for the Volcker Rule to extend to U.S. registered funds. The statute applies to two types of investment funds that are explicitly *excluded* from regulation under the Investment Company Act and, as determined by the Agencies, to funds that are "similar" to those excluded funds. Moreover, a registered fund is not remotely "similar" to a hedge fund or private equity fund. Registered funds are subject to a comprehensive regulatory regime under the Investment Company Act that focuses first and foremost on investor protection, and such funds are designed to be publicly offered and sold to all investors. Hedge funds and private equity funds, on the other hand, are identified in Section 619 by the two sections of the Investment Company Act that keep those funds

outside that Act's regulatory protections. In addition, shares of a hedge fund or private equity fund cannot be sold publicly but rather only to a limited number of investors (in the case of a Section 3(c)(1) fund) or to a carefully defined set of sophisticated investors (in the case of a Section 3(c)(7) fund).

The legislative history of the Dodd-Frank Act reflects the concern of the primary authors of the statute and other members of Congress that the Section 619 definition of hedge fund and private equity fund not be interpreted too broadly. Indeed, members engaged in colloquies to clarify that references to the Section 3(c)(1) and Section 3(c)(7) exclusions under the Investment Company Act should not be read broadly to sweep in subsidiaries, joint ventures, venture capital funds and other structures that rely on those exclusions but "will not cause the harms at which the Volcker rule is directed."[6] It would pervert the intended scope of the Volcker Rule were the Agencies to take too broad a view of what constitutes a "similar fund."

Unfortunately, the Proposed Rule would expand the reach of the Volcker Rule far beyond what Congress intended, even to the extent of sweeping in a number of registered funds. This is because the Proposed Rule includes within its definition of "covered fund" any investment vehicle that is considered a "commodity pool" under Section 1a(10) of the Commodity Exchange Act. Section 1a(10) broadly defines "commodity pool" to include "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests," including, among other things, any security futures product or swap. A registered fund might use security or commodity futures, swaps, or other commodity interests in varying ways to manage its investment portfolio, including for reasons wholly unrelated to providing exposure to the commodity markets.[7] The broad CEA definition of "commodity pool" thus could bring such a registered fund into the Volcker Rule.[8] Providing an express exclusion for registered funds, either in the statute or the implementing regulations, would avoid this result.

Similarly, under the Proposed Rule as drafted, all non-U.S. retail funds (including ETFs) inappropriately are encompassed by the definition of "covered fund." As with U.S. registered funds, there should be an express exclusion from the Volcker Rule for non-U.S. retail funds. Like U.S. registered funds, non-U.S. retail funds are regulated in their home jurisdictions. As a condition of their being offered to retail investors, these funds are regulated with respect, for example, to how they may invest and operate, the disclosure they must provide to their investors, the means by which they value

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[6] *See, e.g.*, 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (colloquy between Sens. Dodd and Boxer).

[7] Uses of these instruments include, for example, hedging positions, equitizing cash that cannot be immediately invested in direct equity holdings (*e.g.*, when the stock market has already closed for the day), managing cash positions more generally, adjusting portfolio duration (*e.g.*, seeking to maintain a stated duration of seven years as a fund's fixed income securities age or mature), managing bond positions in general (*e.g.*, in anticipation of expected changes in monetary policy or the Treasury's auction schedule), or managing the fund's portfolio in accordance with the investment objective stated in the fund's prospectus (*e.g.*, an S&P 500 index fund that tracks the S&P 500 using a "sampling algorithm" that relies in part on S&P 500 or other futures).

[8] As explained in our comment letter, the Agencies may not have contemplated that the CEA definition of "commodity pool" could reach many registered funds. *See* ICI Volcker Comment Letter, *supra* note 4, at 8.

their portfolio securities, their corporate governance, and their use of leverage. They are not managed or structured like hedge funds or private equity funds and so should not be treated as "similar funds" under the Volcker Rule. Providing an exclusion for non-U.S. retail funds would ensure that the Volcker Rule is not applied more restrictively outside the United States than within, a result wholly consistent with Congressional intent to limit the extraterritorial impact of these requirements.

B. The Definition of "Banking Entity" Expressly Should Exclude All U.S. Registered Funds and Their Non-U.S. Counterparts

The Volcker Rule's prohibition on proprietary trading, and its restrictions on activities involving hedge funds and private equity funds, apply to "banking entities."[9] A registered fund would fall within the definition of "banking entity" if it were considered an affiliate or subsidiary of a banking entity (*e.g.,* its investment adviser). In that event, the registered fund itself would be subject to all the prohibitions and restrictions in the Volcker Rule as implemented by the Proposed Rule.

There is no indication that Congress intended this result. It appears that the Agencies did not intend it either; the preamble to the Proposed Rule indicates that a registered fund generally would not be considered a subsidiary or affiliate of the banking entity that sponsors or advises it. Without an express exclusion, however, it remains possible that some registered funds nevertheless could be captured by the regulations as banking entities.

For example, it is common industry practice for an investment adviser/sponsor to provide the initial "seed" capital necessary to launch a new registered fund. During the period following the launch of a new fund, when the banking entity adviser/sponsor may own all or nearly all of the shares of the fund as a result of its investment of seed capital, the registered fund could be considered an affiliate (as defined in the Bank Holding Company Act ("BHCA")) of the adviser/sponsor. If so, the fund would be captured by the proposed definition of "banking entity" and become subject to the Volcker Rule in its own right.[10] This could have the effect of essentially barring banking entities from sponsoring the most highly regulated type of investment vehicle and, thereby, limiting investment options for investors. Further, it would, in effect, ban banking entities from engaging in an activity that is permitted under the BHCA and other federal banking laws and that was never intended to be affected

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[9] The Proposed Rule generally defines "banking entity" to include: (1) an insured depository institution; (2) a company that controls an insured depository institution; (3) a company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978; and (4) subject to certain exceptions, an affiliate or subsidiary of any of the foregoing. "Affiliate" and "subsidiary" are defined by reference to the definitions of those terms in Section 2 of the Bank Holding Company Act.

[10] A similar result could arise in the ETF context, as well as for other types of registered funds, including closed-end funds and unit investment trusts ("UITs"). In particular, there are instances in which a banking entity involved in the underwriting of a closed-end fund or UIT temporarily owns a controlling interest in that fund. We do not believe that Congress intended for the Volcker Rule to interfere with the organization or operation of any type of registered fund.

by the Volcker Rule.[11] It also would put banking entity sponsors at a competitive disadvantage compared with their non-bank-affiliated peers, which have no limits on their ability to furnish seed capital.

For some ICI member firms, the banking entity that triggers application of the Volcker Rule is an insured depository institution that is small in relation to the overall firm and does not constitute part of the firm's core line(s) of business. Ironically, the impracticality that results from applying the Proposed Rule could well cause these firms to discontinue their limited banking operations even though they do not engage in proprietary trading and may not sponsor or have ownership interests in any hedge funds or private equity funds.

Providing an express exclusion for all registered funds from the definition of "banking entity"—either in the implementing regulations or the statute—would address all of the concerns described above without thwarting in any way the policy goals of the Volcker Rule. Even during the post-launch period, when a banking entity investment adviser may own all or nearly all of a fund's shares, the registered fund must be operated in accordance with the comprehensive regulatory regime administered by the SEC under the Investment Company Act and other federal securities laws. Notably in this context, registered funds are subject to oversight by an independent board of directors,[12] strong conflict of interest protections through prohibitions on affiliated transactions,[13] and strict restrictions on leverage.[14]

To avoid the potential for serious and disruptive effects on their organization and operation, the definition of "banking entity" also should expressly exclude non-U.S. retail funds. The justifications for such an exclusion are largely the same as those outlined in Section II.A above with respect to the definition of "hedge fund" and "private equity fund." In particular, the highly regulated nature of non-U.S. retail funds and the intent of Congress to limit the extraterritorial impact of the Volcker Rule provide strong support for excluding these funds from the definition of "banking entity."

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[11] Under the BHCA, banking organizations generally may sponsor and "seed" registered funds so long as they (a) do not exercise managerial control over the portfolio companies of funds, and (b) reduce their ownership stake in sponsored funds to below 25 percent within one year (or seek Federal Reserve Board approval for an extension). 12 CFR 225.86(b)(3).

[12] *See, e.g.*, Section 10(a) of the Investment Company Act (requiring a mutual fund or closed-end fund to have a board of directors at least 40 percent of which must be independent directors. As of year-end 2010, independent directors made up three-quarters of boards in more than 90 percent of fund complexes. Independent Directors Council and Investment Company Institute, *Overview of Fund Governance Practices, 1994–2010* (October 2011).

[13] *See* Section 17(a) of the Investment Company Act; Section 23A of the Federal Reserve Act.

[14] *See, e.g.*, Section 18 of the Investment Company Act (restrictions applicable to mutual funds and closed-end funds).

C. The Volcker Rule Should Not Limit the Ability of Banking Entities to Serve as Authorized Participants and Market Makers for Registered Exchange-Traded Funds

The proprietary trading provisions of the Proposed Rule call into question whether banking entities could continue to serve as Authorized Participants ("APs") and market makers for ETFs registered under the Investment Company Act, as well as non-U.S. retail ETFs. ETFs are similar to mutual funds (the most common type of registered fund) except that they list their shares on a securities exchange, thereby allowing retail and institutional investors to buy and sell shares throughout the trading day at market prices. Increasingly popular with investors, ETFs use a different process for offering their shares. APs alone transact in shares directly with ETFs, in large amounts (typically involving 50,000 to 100,000 ETF shares) based not on market prices but on the ETF's daily net asset value. AP transactions with an ETF are a unique and controlled form of arbitrage trading that, in the view of the SEC, is a critical component of maintaining efficient pricing in the ETF marketplace and protecting ETF investors.

Some banking entities also may engage in traditional market making activities in ETFs. In this capacity, they may provide seed capital, as well as temporarily hold inventory of ETF shares and the underlying securities or their economic equivalent in order to help maintain efficient pricing in the ETF marketplace. Although these are market making activities that should be permitted by the Proposed Rule, we are concerned that they may not be deemed to be "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." We recommend making it clear, either in the implementing regulations or the statute, that banking entities can continue to fulfill these important roles.

III. IMPACT ON THE FINANCIAL MARKETS

Section 619 of the Dodd-Frank Act prohibits a banking entity from engaging in proprietary trading of securities, derivatives, and certain other financial instruments for its own account. Notwithstanding this broad prohibition, the statute provides exemptions for a banking entity to engage in certain "permitted activities." Significantly, exemptions are provided for positions taken in connection with market making-related activities, risk-mitigating hedging activities, and trading in certain U.S. government securities.

ICI supports the overall goals of the Volcker Rule's proprietary trading prohibition, particularly the need to address systemic risk concerns surrounding truly speculative proprietary trading. We do not believe, however, that the Proposed Rule's proprietary trading restrictions, as currently drafted, will achieve these goals. Instead, they may adversely impact the financial markets and the ability of registered funds and other investors to participate in the markets.

A. Liquid and Efficient Markets are Important for Registered Funds

For registered funds, the availability of liquidity is a critical element of efficient markets. Banking entities are key participants in providing this liquidity, promoting the orderly functioning of the markets as well as the commitment of capital when needed by investors to facilitate trading.

Liquidity is particularly important in the everyday operations of mutual funds, which typically offer their shares on a continuing basis and are required by the Investment Company Act to issue "redeemable securities."[15] Mutual funds must have efficient, orderly markets to invest cash they receive when investors purchase fund shares as well as to meet investor redemption requests on a daily basis.

Registered funds also are dependent on adequate liquidity when making investment decisions and when trading the instruments in which they invest. Important investment criteria analyzed by portfolio managers at registered funds include a security's liquidity, *i.e.,* whether a position can easily be sold in a timely and cost efficient manner. If registered funds cannot transact effectively in the financial markets due to a lack of liquidity, they may be reluctant to invest in certain instruments altogether.

We are concerned that the Proposed Rule would decrease liquidity, particularly for those markets that rely most on banking entities, such as the fixed income and derivatives markets and the less liquid portions of the equities markets. A reduction of liquidity would have serious implications for registered funds, ultimately leading to the potential for higher costs for fund shareholders. Non-U.S. retail funds similarly are apprehensive about the prospect of decreased liquidity in these markets, both in the United States, where many of these funds trade, and abroad (particularly with respect to obligations of foreign governments and international and multinational development banks).

B. The Complexity of, and Difficulties of Complying with, the Proposed Rule Threaten Market Liquidity and May Adversely Impact Registered Funds

Much of the concern surrounding the effect of the Proposed Rule on liquidity arises from the complexities of several provisions of the Proposed Rule and of the exemptions from the proprietary trading prohibition. We support recasting the rigid criteria that appear in the Proposed Rule as "guidance" to be incorporated into policies and procedures adopted by banking entities. These policies and procedures could be combined with a robust compliance program required to be employed by banking entities, the use of relevant quantitative metrics to evaluate banking entity trading activity, and examinations by the Agencies to ensure that banks are not engaged in speculative proprietary trading. Together, these measures should accomplish the purposes of the Volcker Rule while permitting the sort of market making activity upon which registered funds and other investors rely.

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[15] *See* Section 2(a)(32) of the Investment Company Act (generally defining "redeemable security" as "any security . . . under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled . . . to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.").

1. The Presumption of Prohibited Activity is Unwarranted

The Proposed Rule generally presumes that a banking entity's short-term principal trading activity is prohibited proprietary trading. While the Proposed Rule provides a mechanism to rebut this presumption, doing so appears extremely complex and onerous. Inevitably, it would expose a banking entity to hindsight interpretations and second-guessing about key compliance decisions with respect to each individual financial position.

This presumption of prohibited activity fundamentally prejudices the analysis of a banking entity's trading activity from the outset. Given the difficulties of overcoming the presumption, banking entities understandably will be highly reluctant to make markets with respect to any instrument that might fall within the proprietary trading prohibition.

2. The Conditions of the Exemptions Do Not Reflect the Operation of the Financial Markets as a Whole

The Proposed Rule appears tailored primarily for the operations of the traditional trading of equities on an agency-based "last sale" model (*i.e.*, on the securities exchanges), the operations of which differ substantially from how the fixed-income and other markets operate. In the majority of the financial markets, market makers provide liquidity by acting as principal, and not as agent. The Proposed Rule therefore does not reflect accurately the manner in which those other financial markets operate: fixed-income securities and derivatives are traded "over-the-counter" rather than on exchanges; their instruments are not as liquid as equities; and the markets and their instruments are more fragmented. As a result, the role of market makers in fixed-income securities and derivatives is more complex and more fundamental to how these markets operate. We are therefore concerned that the Proposed Rule will inhibit the ability of banking entities to conduct market making activities effectively across various asset classes and to supply needed liquidity by acting as principal in a transaction.

The Proposed Rule also does not accord banking entities the flexibility they need as market makers to enter into transactions to build inventory, which is a significant element of making a market. As a result, the exemptions provided in the Proposed Rule from the proprietary trading prohibition, particularly the exemption for market making-related activities, likely will be of very limited utility for banking entities. If that is the case, trading activity that registered funds rely on will be restricted, negatively impacting transaction costs, increasing shareholder risk, and ultimately impacting fund shareholder returns.

3. The Conditions of the Proposed Exemption for Market Making-Related Activities are Impractical

The Proposed Rule's implementation of Section 619's exemption for market making-related activities contains numerous conditions that must be met by a banking entity. We believe these

conditions, as currently drafted, make the exemption extremely complex and so difficult to comply with as to be effectively unworkable in a number of financial markets and for a significant number of financial instruments. For example, the Proposed Rule would require banking entities to ensure that their market making activities generate revenues primarily from fees, commissions, bid/ask spreads or other income that is not attributable to appreciation in the value of covered financial positions held as inventory or hedging of such covered financial positions. As discussed above, market making in fixed-income and derivatives instruments simply does not function in that way, as market makers provide liquidity by acting as principal, and not as agent, in these markets. This condition ignores the fact that market makers holding inventory may seek to generate revenue and profit from the appreciation, and avoid losses from the depreciation, of the covered financial position during the time they hold the position in inventory. Similarly, in less liquid markets where trades are infrequent and customer demand is hard to predict, it may be difficult for a market maker to satisfy the condition that its activity be "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."

4. *The Risk-Mitigating Hedging Exemption Must be Flexible*

The ability of banking entities as market makers to hedge their positions and manage the risks taken in connection with their activities is a critical element of a liquid and efficient market. It is therefore imperative to ensure that banking entities can hedge their positions appropriately to allow them effectively to provide needed services to registered funds. The Proposed Rule's risk-mitigating hedging exemption should not apply on a transaction-by-transaction basis. Rather, it should be flexible enough to allow banking entities to manage all possible risks and to facilitate hedging against overall portfolio risk.

5. *The Proposed Government Obligations Exemption Should be Expanded to Cover All Municipal Securities and Foreign Sovereign Obligations*

The proposed exemption for trading in certain government obligations does not extend to transactions in obligations of an agency or instrumentality of any State or political subdivision. We submit that there is no rational basis upon which to exclude this particular class of municipal securities. These instruments represent one of the more conservative asset classes in the capital markets, and registered funds are significant investors in these securities. Excluding this class of municipal securities will restrict trading in these instruments and pose liquidity challenges for registered funds holding these securities. Moreover, it will impair the ability of many local government entities to raise capital, with significant adverse consequences for the finances of these entities. We therefore recommend that the exemption be expanded, either in the statute or the implementing regulations, to include all municipal securities, which would be consistent with the current definition of municipal securities under the Securities Exchange Act of 1934 ("Exchange Act"). We further recommend that there be an exemption for foreign sovereign obligations, consistent with Congressional intent to limit the extraterritorial reach of the Volcker Rule and with the purposes of the Volcker Rule.

C. The Agencies' Proposed Implementation of the Proprietary Trading Prohibition Would Impact Capital Formation

The Agencies' proposed implementation of the proprietary trading prohibition could have negative implications for capital formation. Banking entities play a critical role in initial capital formation, often providing companies with the capital necessary to go public. If banking entities find that the restrictions contemplated by the Proposed Rule prohibit or greatly impede their serving this role, they will be less willing to provide capital, adversely affecting registered funds and other investors. Similarly, if issuers and dealers face increased costs in the capital formation process due to the Proposed Rule, this could restrict access for registered funds to suitable investments, and the availability of investments for registered funds overall will decline.

Banking entities also may find it difficult to remain in the market making business, which could lead these activities to be performed by less regulated and less transparent institutions. We therefore believe the over-broad restrictions of the Proposed Rule, which go well beyond what is necessary to effectuate Congress' intent in enacting Section 619 of the Dodd-Frank Act, could hurt the broader economy, impacting job creation and investments in U.S. businesses overall.

IV. LIMITING INVESTMENT OPPORTUNITIES FOR REGISTERED FUNDS AND THEIR SHAREHOLDERS

A. The Foreign Trading Exemption Should Be Revised to Avoid Adverse Effects on Investments in Certain Foreign Securities by U.S. Registered Funds and Their Foreign Counterparts

Although Congress intended that trading outside of the United States be a "permitted activity" under the Volcker Rule, the Proposed Rule narrowly defines transactions deemed to take place outside of the United States. In so doing, the Proposed Rule departs from an existing and well-understood U.S. securities regulation (Regulation S under the Securities Act of 1933) that governs whether an offering takes place outside of the United States. If left unaddressed, the discrepancy between the "foreign trading exemption" in the Proposed Rule and the long-established Regulation S standard would have negative consequences for U.S. registered funds and their shareholders.

Many registered funds invest in securities, such as sovereign debt securities denominated in foreign currency, for which the primary and most liquid market is outside of the United States. These transactions often involve non-U.S. banking entities as counterparties. The narrow foreign trading exemption in the Proposed Rule may well cause some non-U.S. banking entities to avoid engaging in transactions with persons acting on behalf of U.S. registered funds, even when those transactions would comport fully with Regulation S and related SEC interpretations. As a result, U.S. registered funds' access to non-U.S. counterparties could decrease significantly.

As currently configured, the foreign trading exemption also could reduce liquidity in some markets and lead to smaller or more fragmented markets for many securities. This would have adverse effects on investors in those markets including both U.S. registered funds and non-U.S. retail funds.

Revising the Proposed Rule (or the statute) to conform to the existing approach under Regulation S would avoid these highly undesirable results.

B. The Volcker Rule Should Exempt Asset-Backed Commercial Paper and Municipal Tender Option Bond Programs

The Proposed Rule would impair two particular types of securitization activities that are part of traditional banking activities—notes issued by asset-backed commercial paper ("ABCP") programs and securities issued pursuant to municipal tender option bond ("TOB") programs. This would have significant negative implications for issuers of these financing vehicles and their investors, many of which are registered funds. There is no indication, however, that Congress intended to include ABCP or municipal TOB programs within the scope of the Volcker Rule; rather, Congress specifically sought to avoid interfering with longstanding, traditional banking activities. The provision of credit to companies to finance receivables through ABCP, as well as to issuers of municipal securities to finance their activities through TOBs, are both areas of traditional banking activity that should be distinguished from the types of financial activities that Congress sought to restrict under the Volcker Rule. Without liquid ABCP and TOB markets, credit funding for corporations and municipalities would be unduly and unnecessarily constrained. It is therefore important that the statute or implementing regulations be revised to exempt ABCP and municipal TOB programs.

V. CONCLUSION

I appreciate the opportunity to share these views with the Committee. ICI looks forward to working with Congress and regulators as they continue to tackle these and other important issues.

Attachment

- Appendix: Proposed Amendments to Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Volcker Rule")

Revised as of December 12, 2012

APPENDIX

Proposed Amendments to Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Volcker Rule")[16]

I. Amendments to Clarify that the Volcker Rule Does Not Extend to U.S. Mutual Funds or Their Non-U.S. Counterparts

A. Amendment to Section 13(h)(2) of the Bank Holding Act of 1956, which defines the terms "hedge fund" and "private equity fund":

Add the following language at the end of the paragraph:

In no event shall the terms "hedge fund" or "private equity fund" (including any similar fund as designated by rule) mean—

(A) an investment company registered under the Investment Company Act of 1940;

(B) an issuer organized or formed under foreign law that is authorized for public sale in the jurisdiction in which it is formed and is regulated as a public investment company, regardless of the form of organization, in that jurisdiction; or

(C) an issuer that is subject to contractual or other restrictions that effectively limit its investment objectives, policies and strategies to those objectives, policies and strategies that would be permitted for investment companies registered under the Investment Company Act of 1940.

EXPLANATION:

- Section 619 of the Dodd-Frank Act prohibits a banking entity from having an ownership interest in, or acting as sponsor to, a hedge fund, private equity fund, or "similar fund" as the agencies charged with implementing the Volcker Rule may determine by rule.

- Treating *any* mutual fund or other U.S. registered investment company as "similar" to a hedge fund or private equity fund is contrary to Congressional intent. If the term "similar fund" is interpreted broadly by the regulators, however—as we have seen in the pending proposal to implement the Volcker Rule—some registered funds may become subject to the Volcker Rule prohibitions. Providing an express exclusion for mutual funds and other U.S. registered investment companies

[16] Section 619 added Section 13 (Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds) to the Bank Holding Company Act of 1956.

from the definition of "hedge fund" and "private equity fund" would avoid this result.

- There likewise should be an express exclusion for non-U.S. retail funds from the definition of "hedge fund" and "private equity fund" to treat them similarly to their U.S. mutual fund counterparts. Like U.S. registered investment companies, non-U.S. retail funds are regulated in areas such as how they may invest and operate, the disclosure they must provide to their investors, the means by which they value their portfolio securities, their corporate governance, and their use of leverage, in order to be widely offered to retail investors. They are not managed or structured like hedge funds or private equity funds and so should never be categorized as "similar funds."

- Without such a corollary exclusion for non-U.S. retail funds, the Volcker Rule would be applied more restrictively outside the United States. Further, providing an express exclusion for non-U.S. retail funds from the definition of "hedge fund" and "private equity fund" is consistent with Congressional intent to limit the extraterritorial impact of the Volcker Rule.

- The language of the proposed exclusion for non-U.S. retail funds is substantially similar to that used by the Securities and Exchange Commission in 2004, when it identified the types of non-U.S. funds that should not be treated as hedge funds.[17] As in the SEC's rulemaking, the proposed exclusion should apply to any type of publicly offered fund otherwise meeting the requirements of the exclusion, whether in corporate, trust, contractual or other form.

- It also is unnecessary to apply the Volcker Rule prohibitions to funds that, because of contractual or other restrictions, effectively limit their investment objectives, policies and strategies to those that would be permitted for U.S. registered investment companies under the Investment Company Act of 1940 (*e.g.*, limitations on leverage). These parameters are well understood by the investment management industry and by the SEC, which is the primary regulator of registered investment companies and advisers to certain hedge funds and private equity funds.

- In addition, excluding the funds described in (C) above from the scope of Section 619 would be consistent with the Financial Stability Oversight Council's recommendation that the "similar fund" designation be reserved for funds that "engage in the activities or have the characteristics of a traditional private equity fund or hedge fund."[18]

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[17] *See* Registration under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004). This rulemaking was vacated by the U.S. Court of Appeals for the District of Columbia Circuit on grounds unrelated to this particular provision. *See Goldstein v. Sec. & Exch. Comm'n*, 451 F.3d 873 (D.C. Cir. 2006).

[18] *See* Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (Jan. 2011), at 62.

Revised as of December 12, 2012

B. Amendment to Section 13(h)(1) of the Bank Holding Company Act of 1956, which defines the term "banking entity":

Add the following language at the end of the paragraph:

In no event shall the term "banking entity" mean—

(A) an investment company registered under the Investment Company Act of 1940;

(B) an issuer organized or formed under foreign law that is authorized for public sale in the jurisdiction in which it is formed and is regulated as a public investment company, regardless of the form of organization, in that jurisdiction; or

(C) an issuer that is subject to contractual or other restrictions that effectively limit its investment objectives, policies and strategies to those objectives, policies and strategies that would be permitted for investment companies registered under the Investment Company Act of 1940.

EXPLANATION:

- The Volcker Rule prohibits a "banking entity" from engaging in proprietary trading and from sponsoring or investing in hedge funds and private equity funds. The definition of "banking entity" includes an affiliate or subsidiary of a banking entity.

- A mutual fund generally is not considered an affiliate or subsidiary of the banking entity that sponsors or advises it. Without an express exclusion, however, it is possible that some mutual funds or other U.S. registered investment companies could become subject to all of the prohibitions and restrictions in the Volcker Rule—a result not intended by Congress. For example, during the period following the launch of a new mutual fund by a bank-affiliated sponsor, when all or nearly all of the fund's shares are owned by that sponsor (the "seeding process" for a new fund), the mutual fund could be considered an affiliate of the banking entity, and thus subject to the Volcker Rule in its own right.

- Providing an express exclusion for mutual funds (and other U.S. registered investment companies) from the definition of "banking entity" would avoid this unintended result without thwarting in any way the policy goals of the Volcker Rule.

- Consistent with Congress' intent to limit the extraterritorial impact of the Volcker Rule, the exclusion also should extend to non-U.S. retail funds (*i.e.,* the non-U.S. counterparts to U.S. mutual funds). Like U.S. registered investment companies, non-U.S. retail funds are regulated in areas such as how they may invest and operate, the disclosure they must provide to their investors,

the means by which they value their portfolio securities, their corporate governance, and their use of leverage, in order to be widely offered to retail investors.

- The language of the proposed exclusion for non-U.S. retail funds is substantially similar to that used by the SEC in 2004, when it identified the types of non-U.S. funds that should not be treated as hedge funds.[19] As in the SEC's rulemaking, the proposed exclusion should apply to any type of publicly offered fund otherwise meeting the requirements of the exclusion, whether in corporate, trust, contractual or other form.

- It also is consistent with Congressional intent to exclude from the definition of "banking entity" funds that, because of contractual or other restrictions, effectively limit their investment objectives, policies and strategies to those that would be permitted for U.S. registered investment companies under the Investment Company Act of 1940 (*e.g.*, limitations on leverage). Such funds do not present the risks at which the Volcker Rule prohibitions are directed.

II. Amendment to Clarify that the Volcker Rule Permits Market Making Activity by Authorized Participants in Exchange-Traded Funds

Insert the following language as Section 13(d)(1)(C), (and redesignate successive subparagraphs (C) through (J) as (D) through (K)):

(C) The purchase, sale, acquisition, or disposition of securities issued by Exchange-Traded Funds ("ETF Shares"), or underlying securities held by an ETF (or other instruments reasonably intended to provide substantially similar economic exposure)

(i) in connection with ETF market making-related activities, or

(ii) by Authorized Participants in connection with the creation and redemption of ETF Shares.

EXPLANATION:

- Exchange-traded funds ("ETFs") have over $1 trillion in assets under management, and are an important investment vehicle for a wide range of investors. A robust trading environment is critical for the ETF market.

- Banking entities play an important role in this market by acting as Authorized Participants ("APs") and market makers. An AP is an entity that enters into a contract with an ETF permitting it to purchase and sell shares directly with the ETF at the ETF's net asset value.

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[19] *See* Registration under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004). This rulemaking was vacated by the U.S. Court of Appeals for the District of Columbia Circuit on grounds unrelated to this particular provision. *See Goldstein v. Sec. & Exch. Comm'n*, 451 F.3d 873 (D.C. Cir. 2006).

- In their role as APs and market makers, banking entities may, among other things:

  1. "Seed" new ETFs, by providing initial capital and holding shares of an ETF until a liquid trading market develops.

  2. Engage in short term arbitrage transactions, creating ETF shares when such shares trade at a premium (i.e., when demand exceeds supply) and redeeming them when they trade at a discount (i.e., when supply exceeds demand); this activity helps to keep the market price for ETF shares close to their net asset value. The SEC views this arbitrage process as a critical component of maintaining efficient pricing in the ETF marketplace and protecting ETF investors from the risks of substantial and sustained deviations from net asset value.[20]

  3. Temporarily hold inventory of ETF shares and the underlying securities or their economic equivalent in order to maintain efficient pricing for ETFs.

- These activities may fall within the definition of "proprietary trading" in subsection (h)(4) of Section 13, and they do not clearly fit within the "permitted activities" exemptions enumerated in subsections (d)(1)(A) through (I) of Section 13.

  - Although the activities described above relate to market making in ETF shares, the existing exemption in subsection (d)(1)(B) for market making-related activities is too narrow because of its requirement that such activities be "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."

- These activities relating to ETF shares do not create the risks that the Volcker Rule was intended to address.

- The proposed change would provide certainty to the ETF marketplace that banking entities can continue to act as APs and engage in market making-related activity with respect to ETF shares. Other ways to achieve this objective include:

  - Revising the definition of "proprietary trading" in Section 13(h)(4) to exclude trading in ETF shares and underlying securities held by an ETF (or other instruments reasonably intended to provide substantially similar economic exposure)

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[20] A primary concern for the SEC in its efforts to establish a regulatory framework for ETFs was to ensure that the process for this type of trading could function effectively. *See* Part IV.B of SEC Release No. IC-25258 (November 17, 2001). ETF exemptive orders contain conditions specifically designed to provide for a sufficiently robust, but controlled, arbitrage process. *See, e.g.*, In the Matter of Pacific Investment Management Company LLC, et al, SEC Release Nos. IC-28949 (October 20, 2009 (notice)) and IC-28993 (November 10, 2009 (order)); and In the Matter of Claymore Exchange-Traded Fund Trust 3, et al, SEC Release Nos. IC-29256 (April 23, 2010 (notice)) and IC-29271 (May 18, 2010 (order)).

- Directing the agencies charged with implementation of the Volcker Rule to ensure that the activities permitted under the market making exemption in Section 13(d)(1)(B) include the activities described herein.

III. Amendment to Expand the Government Obligations Exemption

Revise Section 13(d)(1)(A) of the Bank Holding Company Act of 1956 as follows:

(A) The purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.), and ~~obligations of any State or of any political subdivision thereof~~ municipal securities, as defined in section 3(a)(29) of the Securities Exchange Act of 1934.

EXPLANATION:

- The Section 619 exemption for trading in certain government obligations does not extend to transactions in obligations of an *agency or instrumentality* of any State or political subdivision. The exemption should be expanded to include these securities, which would be consistent with the current definition of municipal securities under the Securities Exchange Act of 1934.

- Obligations issued by state agencies and instrumentalities represent one of the more conservative asset classes in the capital markets, and are estimated to account for almost half of the securities currently outstanding in the municipal securities market.

- Banking entities currently play a significant role in underwriting and facilitating a secondary market for municipal securities of agencies and instrumentalities. Failure to include such trading as a permitted activity would impair the ability of many local government entities to raise capital, with significant adverse consequences for the finances of these entities.

IV. Amendment to Clarify the Scope of the Permitted Activity Exemptions Involving Transactions and Activities Occurring Solely Outside the United States

Add the following paragraph as new subsection (i) of Section 13 of the Bank Holding Company Act of 1956:

(i) For purposes of determining which transactions and activities are considered to be "permitted activities" within the meaning of subsection (d) or otherwise outside the scope of the prohibitions in this section, any transaction or activity that takes place in accordance with Regulation S under the Securities Act of 1933, and interpretations thereunder, shall be deemed to have occurred "solely outside the United States." In addition, the term "resident of the United States" shall mean a "U.S. person" as defined in Regulation S under the Securities Act of 1933, and interpretations thereunder.

EXPLANATION:

- Congress expressly limited the extraterritorial application of the Volcker Rule through two "permitted activity" exemptions: (1) an exemption for trading conducted by a non-U.S. banking entity solely outside the U.S. (known as the foreign trading exemption), and (2) an exemption for investment fund activities by a non-U.S. banking entity solely outside the U.S. (known as the foreign fund exemption).

- For more than 20 years, Regulation S under the Securities Act of 1933 has been the global standard for delineating the U.S. and non-U.S. securities markets. Regulation S governs whether a securities offering takes place outside of the U.S. and therefore is not subject to U.S. registration requirements. Market participants around the world, including U.S. registered investment companies, have built their compliance systems and processes based on Regulation S.

- There is no indication that Congress intended to create a new or different standard for delineating U.S. and offshore securities activities for purposes of the Volcker Rule. Unfortunately, the pending proposal to implement the Volcker Rule would depart from the existing Regulation S standard, by narrowly defining the transactions that would be considered to take place outside the United States. Such an approach could have negative consequences for U.S. registered funds and their shareholders.

- For example, many U.S. registered funds with foreign subadvisers invest in securities, such as sovereign debt securities denominated in foreign currency, for which the primary and most liquid market is outside of the United States. These transactions often involve non-U.S. banking entities as counterparties. If the Volcker Rule is interpreted too narrowly, some non-U.S. banking entities may avoid engaging in transactions with persons acting on behalf of U.S. registered funds. As a result, U.S. registered funds' access to non-U.S. counterparties could decrease significantly, and liquidity in some markets could be reduced.

- Including an express statement in the statute that the foreign activity exemptions (and the Volcker Rule generally) should operate consistent with Regulation S and interpretations thereunder would avoid these highly undesirable results.

V. Amendments to Clarify that the Volcker Rule Does Not Extend to Asset-Backed Commercial Paper or Tender Option Bond Programs

A. Amendment to Section 13(h)(2) of the Bank Holding Act of 1956, which defines the terms "hedge fund" and "private equity fund":

Add the following language at the end of the paragraph:

In no event shall the terms "hedge fund" or "private equity fund" (including any similar fund as designated by rule) mean

(A) an issuer that is a Special Purpose Entity as defined in Rule 2a–7 under the Investment Company Act of 1940 (17 CFR 270.2a–7(a)(3)), the assets or holdings of which are substantially comprised of Qualifying Assets, as defined in Rule 2a–7 (17 CFR 270.2a–7(a)(3)); or

(B) an issuer that is a trust, the assets or holdings of which are substantially comprised of municipal securities, as that term is defined in Section 3(a)(29) of the Securities Exchange Act of 1934.

B. Amendment to Section 13(h)(1) of the Bank Holding Company Act of 1956, which defines the term "banking entity":

Add the following language at the end of the paragraph:

In no event shall the term "banking entity" mean—

(A) an issuer that is a Special Purpose Entity as defined in Rule 2a–7 under the Investment Company Act of 1940 (17 CFR 270.2a–7(a)(3)), the assets or holdings of which are substantially comprised of Qualifying Assets, as defined in Rule 2a–7 (17 CFR 270.2a–7(a)(3)); or

(B) an issuer that is a trust, the assets or holdings of which are substantially comprised of municipal securities, as that term is defined in Section 3(a)(29) of the Securities Exchange Act of 1934.

EXPLANATION:

- The Volcker Rule prohibits a "banking entity" from engaging in proprietary trading and from having an ownership interest in or sponsoring a "hedge fund" or a "private equity fund." The definition of "hedge fund" and "private equity fund" includes an issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for Section 3(c)(1)

or 3(c)(7) of that Act. The definition of "banking entity" includes an affiliate or subsidiary of a banking entity.

- In enacting the Volcker Rule, Congress specifically sought to avoid interfering with longstanding, traditional banking activities. Without further clarification, however, the Volcker Rule would impair two types of securitization activities that are part of traditional banking activities—notes issued by asset-backed commercial paper ("ABCP") programs and securities issued pursuant to municipal tender option bond ("TOB") programs.

- Application of the Volcker Rule to ABCP and TOB programs would have significant negative implications for issuers of these financing vehicles and their investors, many of which are U.S. registered funds. The provision of credit to companies to finance receivables through ABCP, as well as to issuers of municipal securities to finance their activities through TOBs, are both areas of traditional banking activity that should be distinguished from the types of financial activities that Congress sought to restrict under the Volcker Rule. Without liquid ABCP and TOB markets, credit funding for corporations and municipalities would be unduly and unnecessarily constrained.

- Although application of the Volcker Rule to these programs clearly was not intended by Congress, clarification is needed because ABCP and TOB issuers typically rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. As a result, they would be captured by the definition of "hedge fund" or "private equity fund," despite the fact that they have none of the characteristics of a hedge fund or private equity fund. Similarly, an ABCP or TOB program would fall within the definition of "banking entity" if it were considered an affiliate of a banking entity (*e.g.*, because the banking entity is acting as sponsor of that ABCP or TOB program). To address these concerns, ABCP and TOB programs should be expressly excluded from the definition of "hedge fund" and "private equity fund" and from the definition of "banking entity."

* * * * *

The specific recommendations outlined above address only a fraction of the very significant concerns about the Volcker Rule that have been voiced by many stakeholders and that should be considered as part of any effort to develop a less burdensome alternative. As part of any such alternative, the Committee should include a conformance period of sufficient length that would begin to run upon adoption of final implementing rules by the various regulatory agencies. It is imperative that banking entities and other market participants be given adequate time to understand the new regulatory requirements and to adjust their business models and practices accordingly. Structuring the conformance period in this way would allow an orderly transition and minimize market disruptions.

BREAKINGVIEWS
Agenda-setting financial insight

REUTERS

Thursday, 13 December 2012

Licking TBTF

Too big to fail looks on its way to being licked

12 December 2012 | By Rob Cox

Has the too big to fail problem been licked? The Bank of England and Federal Deposit Insurance Corp sound pretty confident, declaring this week they're nearly in a position to resolve a systemic failure without inflicting losses on taxpayers. It's hard to know without a test case. But the signal from capital markets suggests watchdogs may be on to something.

Though the wider public may still think big swinging bankers will get bailed out in a crisis, investors in U.S. bank debt are taking no chances. In fact, the nation's biggest financial institutions are paying more to fund their loan books on a relative basis in the credit default swaps market than are similarly rated industrial companies. More importantly, it costs them more than their smaller rivals.

The top six U.S. banks and brokers, those with balance sheets larger than $750 billion, recently paid an average premium on their unsecured five-year debt of about 129 basis points above the risk-free rate, according to Credit Suisse's Liquid US Corporate Index. Furthermore, the biggest banks paid more than the average of 15 regional and trust banks also analysed by Credit Suisse. Funding for these smaller institutions cost 12 basis points less in the markets.

The implication is that despite their size and that some of these banks were rescued in the 2008 panic, investors consider holding their debt a riskier proposition. That bolsters claims by regulators that new rules giving them the authority to shutter failing banks are sinking in.

True, the bank deposit market may reflect lingering doubts. FDIC data show that since the crisis, banks with over $10 billion of assets pay less to depositors than smaller ones. In the second quarter, they paid 20 basis points less. This could be down to more extensive branch and ATM networks, higher marketing spending and a greater array of products than any conscious decision by customers to keep savings in the vaults of institutions perceived as infallible.

Until a major, failing bank is wound down by a government at the expense of bondholders as well as shareholders the verdict will be undecided on the fate of too big to fail. It's encouraging, however, to see investors finally recognising the possibility.

Context News

The Bank of England and the U.S. Federal Deposit Insurance Corp said in a joint paper released on Dec. 10 that each country's plans for dealing with the types of cataclysmic financial failures that marked the 2007-2009 financial crisis would reduce risks to financial stability.

"The FDIC and the Bank of England have developed resolution strategies that take control of the failed company at the top of the group, impose losses on shareholders and unsecured creditors - not on taxpayers - and remove top management and hold them accountable for their action," they said in the paper.

The new authorities to seize and resolve so-called global systemically important financial institutions came in the United States from the 2010 Dodd-Frank financial reform law, and in Britain from the anticipated approval by early 2013 of the European Union Recovery and Resolution Directive.

American Council of Life Insurers (ACLI) Statement for the Record
House Financial Services Committee
Hearing entitled "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Part II"

December 13, 2012

The American Council of Life Insurers (ACLI) is pleased to submit this statement for the hearing record expressing the concerns of the life insurance industry about the implementation of Section 619 of the Dodd-Frank Act (DFA), commonly referred to as the Volcker Rule. ACLI strongly supports the business of insurance exclusion to the Volcker Rule that was explicitly authorized by Congress in the Dodd-Frank Act and believes it should not be diminished or undermined by rulemaking in any way.

The American Council of Life Insurers is a Washington, D.C.-based trade association with more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. ACLI advocates in federal, state and international forums. Its members represent more than 90 percent of the assets and premiums of the U. S. life insurance and annuity industry. In addition to life insurance, annuities and other workplace and individual retirement plans, ACLI members offer long-term care and disability income insurance, and reinsurance. Its public website can be accessed at www.acli.com.

Insurer Investments Support Guarantees Made to Families, Savers, and Retirees

Life insurers' financial products protect millions of individuals, families, retirees, and businesses through guaranteed lifetime income, life insurance, long-term care and disability income insurance. These products provide Americans with financial security through various stages of life and enable them to plan for their financial future, including retirement. Unlike nearly all other financial institutions, life insurers' obligations to policyholders are generally long-term, often extending for decades. In order to meet their obligations to policyholders, life insurers must acquire assets that match their liabilities. Accordingly, they are major institutional investors that provide a significant source of funding for issuers and liquidity for the financial markets in general.

Insurance companies collect premiums from customers in return for a promise to pay benefits to those customers at some future point. During the time between the collection of premiums and the payout of benefits, the insurer takes ownership of those premium dollars and invests them in conservative yet sophisticated ways in order to ensure that sufficient funds exist in the future to pay benefits when they come due. Although insurance companies are most certainly not 'proprietary trading institutions', their fundamental business model requires them to invest the company's own money in order to ensure a healthy portfolio for paying customer benefits and prudently running the company. In addition, as is expected and desired from sophisticated investors, insurers regularly use

risk-mitigating hedging strategies to protect investment portfolios against interest rate risks, equity risks, credit risks and foreign exchange risks so that market movements do not endanger the health of the company or the company's ability to fulfill its promises to its policyholders.

The Financial Stability Oversight Council, in its 2011 study on the Volcker Rule, recognized the unique nature of insurance company investment activity, stating, "The investment activity of [insurance] companies is central to the overall insurance business model and could be unduly disrupted if certain provisions of the Volcker Rule applied."

Insurance Company Investments are Highly Regulated

Insurance company investment activities are subject to rigorous oversight and examination by state insurance regulators. State regulators have comprehensive regulatory and reporting regimes for examining an insurer's investment activities and guarding against excessive risk in their investment portfolios.

State insurance laws are specifically designed to promote the safe and sound operation of insurance companies *inter alia* by establishing limits and diversification requirements and by fostering investments in longer-term instruments that more appropriately correspond to the long-term liability structure of insurance companies. These laws directly impact prudent product design and help reduce the risk presented by the unique nature of insurance operations.

State insurance laws and regulations address many other aspects of the business of insurance, including, importantly, financial matters such as standards of solvency, statutory reserves, reinsurance and capital adequacy. Each insurance company is required to file reports, generally including detailed annual financial statements, with state insurance regulators in each of the jurisdictions in which it does business, and its operations and accounts are subject to periodic examination by such authorities. Each insurance company is subject to risk-based capital requirements, and reports its risk-based capital based on a formula calculated by applying factors to various asset, premium and statutory reserve items, as well as taking into account the risk characteristics of the insurance company. The formula is used as an early warning regulatory tool to identify possible inadequately capitalized insurance companies for purposes of initiating regulatory action. Insurance laws provide state insurance regulators the authority to require various actions by, or take various actions against, insurance companies whose risk-based capital ratio does not meet or exceed certain levels.

The Financial Stability Oversight Council, in its 2011 study on the Volcker Rule, recognized the existing constraints placed on insurer investments and the quality of supervision of these activities by state agencies, stating the following:

- "Insurance company investment is subject to relevant state investment laws which, while not uniform, are substantially similar and generally conform to standards set out in model laws and regulations developed by the National Association of Insurance Commissioners ("NAIC"). State investment laws aim at limiting the amount and type of investments insurers can make in order to limit their investment and counterparty risk exposure. For example, among other limitations, investment laws limit the amount of investment an insurer can make in equities, low-grade securities, or in the securities of any one issuer."

- "State insurance company investment laws and regulations govern the type of investment, and extent of such investments, an insurance company can include as "admitted" assets on their balance sheet for the purpose of determining whether the insurance company has the ability to discharge its obligations and meet capital and surplus requirements. Insurance companies can make otherwise prohibited investments, but such investments are not considered admitted assets and still have to be reported to state insurance regulators."

- "State agencies monitor insurer investments, through reporting, valuation, and examination, to ensure that such investments are in compliance with state insurance investment laws, regulations, and guidance, and, even when insurers are otherwise in compliance to ensure that such investments do not threaten the solvency of the insurer."

Congress Established the Business of Insurance Exclusion in DFA

In recognition of the unique insurance business model and the existing investment safeguards enforced by state insurance supervisors, Congress expressly authorized a business of insurance exclusion to the Volcker Rule in the Dodd-Frank Act. Congress recognized the need to "appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws." The specific reference to insurance company *investment* laws makes it clear that the accommodation required under the Volcker Rule relates both to the proprietary trading restrictions and the private equity and hedge fund investment restrictions.

The Final Rule Must Follow Congressional Intent and Accommodate the Business of Insurance

The business of insurance exclusion established by Congress applies to all insurance company investment activity. Rulemaking which prohibits an insurance company from engaging in any investment activity that is allowed under applicable insurance law would be inconsistent with the principle of accommodating the business of insurance. Therefore, the proposed rules should be revised and clarified to accommodate insurance investment activities.

In addition to the above, life insurers are also concerned that the Volcker Rule could impair market making, liquidity and depth in the securities markets. If the proposed regulations impede an insurance company's ability to manage its fixed income portfolio and to enter into and manage hedging transactions, the direct and indirect costs of reduced liquidity could ultimately cause higher premiums for customers or reduced product options and features. To ensure the efficient operation of securities markets and prevent increases in transaction costs, the final rule should implement the market making exception in a less restrictive manner that would not constrain liquidity.

Thank you for convening this important hearing and for your consideration of the views of ACLI and its member companies.

BBVA Compass

Lawrence R. Uhlick
Chairman of the Board

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Birmingham, AL 35233

larry.uhlick@bbvacompass.com

December 12, 2012

The Honorable Spencer Bachus
Chairman, Financial Services Committee
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Bachus,

We appreciate the oversight you and your colleagues on the House Financial Services Committee are conducting around the regulatory implementation of the Volcker Rule. In addition to this week's hearing on this topic, we applaud your efforts to encourage thoughtful improvements and coordinated finalization of the proposed rule by the federal financial regulators, including a two-year implementation period once the rule is finalized as expressed in your letter to those regulators on November 29th.

We continue to believe that Congress and the federal financial regulators should seek to minimize the tremendous regulatory burden that the current Volcker Rule proposal would impose on the banking industry. The rule as proposed would have negative consequences on our ability to serve our customers, as well as on financial markets and economic growth.

In our September 7th letter to you, we submitted a brief discussion of some of our major concerns with the proposed Volcker Rule and our recommendations for alternative approaches. As indicated in our letter, we believe the Volcker Rule as proposed would impose enormous burdens on regional banks, such as BBVA Compass, when our trading activities, or lack of certain trading activities, pose no risk to the U.S. financial system. There would also be significant negative consequences from the extraterritorial reach of the rule which is contrary to the longstanding practice of deference to home country regulation. We have enclosed our September letter today and respectfully request that you considering including it in the record of the Committee's December 13th hearing.

As always, please let me or Josh Denney know whenever we can be of assistance.

With best regards,

Larry

Lawrence R. Uhlick
Chairman

cc: The Honorable Barney Frank, Ranking Member, House Financial Services Committee

Enclosure (1)

BBVA Compass is a trade name of Compass Bank, a member of the BBVA Group. Compass Bank, Member FDIC.

15 South 20th Street
Birmingham, AL 35233

September 7, 2012

The Honorable Spencer Bachus
Chairman
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Bachus:

BBVA Compass Bancshares, Inc. ("BBVA Compass") very much appreciates your request for input on how to formulate a less burdensome alternative to Section 13 of the Bank Holding Company Act of 1956, commonly known as the Volcker Rule. We strongly support and encourage over time a thorough exploration of possible legislative reforms and alternatives to the current statutory language.

With the benefit of further Congressional input regarding the federal financial regulators' proposal to implement the Volcker Rule, we strongly urge that the final regulations address the many concerns that have been publicly expressed to both the agencies and Congress. We believe that Congress and the federal financial regulators should seek to minimize the tremendous regulatory burden that the current proposal would impose on the banking industry which would have negative consequences on our ability to serve our customers, as well as on financial markets and economic growth.

We have set forth below a brief discussion of some of our major concerns with the proposed Volcker Rule and our recommendations for alternative approaches.

Executive Summary

- BBVA Compass supports regulation and reasonable monitoring of trading activities that bear a higher level of risk to a bank or banking system. We are concerned, however, that the proposal for implementation of the Volcker Rule would create costly and burdensome obligations on entities whose trading activities, or lack of trading activities, pose no risk to the U.S. financial system. Instead, community and regional banks like ours that do not engage in propriety trading should be able to simply certify to our regulators that we are not engaged in prohibited activities.

- Additionally, the dollar threshold triggering the need for an extensive and prescriptive compliance program should be raised from $1 billion to at least $10

billion in average trading assets and liabilities. This change would still require an extensive compliance program of the companies that control more than 97 percent of the total trading assets and trading liabilities in all U.S. banking organizations.

- Dodd-Frank's plain language exemption from the Volcker Rule for activities conducted outside the U.S. should not be interpreted to prohibit other connections to the United States, such as using an American exchange or transacting with an American counterparty. If the regulators' narrow interpretation of the exemptions for non-U.S. activities is left unchanged in final regulations, the result will be reduced liquidity in U.S. markets and securities and migration of trading activities to other jurisdictions, all of which will result in job losses in the U.S.

- It appears that foreign banking entities engaged in activities entirely outside of the U.S. could still be subject to Volcker Rule compliance requirements. This would be contrary to the longstanding practice of deference to home country supervision and prudential regulation. Foreign entities engaged in proprietary trading and covered funds activities outside the U.S. should not be required either to refrain from those activities or institute the types of compliance programs and reporting systems required by the proposed regulations.

- The proposed Volcker Rule permits trading of U.S. government securities but does not permit similar trading in non-U.S. sovereign securities. The final rule should allow trading in all government securities. Other supervisory authorities provide more appropriate and flexible ways for regulators to address any concerns regarding bank exposure to non-U.S. sovereign debt.

Discussion of Volcker Rule Alternatives

I. Compliance Program Requirements

The Volcker Rule generally prohibits banking entities, including foreign banking entities, from engaging in proprietary trading or sponsoring, acquiring or retaining an interest in covered hedge and private equity funds. BBVA Compass does not engage in proprietary trading nor does it sponsor or retain an interest in covered hedge and private equity funds. The same is true for our banking subsidiary, Compass Bank. Compass Bank is a regional bank that operates more than 700 branches in Alabama, Arizona, California, Colorado, Florida, New Mexico and Texas. Compass Bank ranks among the top 20 largest U.S. commercial banks based on deposit market share.

BBVA Compass does not oppose sensible regulation of activities that pose risk to financial institutions, such as reasonable monitoring and risk control standards. However, BBVA Compass does have significant concerns about the excessive cost and complexity of complying with the proposed implementing regulations because BBVA Compass and its affiliates would expend significant resources to implement compliance plans that provide no meaningful benefits to customers, taxpayers or the U.S. financial system. Committing such resources would detract from our ability to serve customers. Resources used to prove that BBVA Compass or Compass Bank is *not* engaged in

proprietary trading or prohibited fund activities would be better deployed to lending and serving customers in general.

A. Scope of Compliance Programs for Entities Not Engaged in Prohibited Trading

The Volcker Rule was intended to prohibit proprietary trading and acquiring or holding interests in hedge funds or private equity funds. Nevertheless, the proposed implementing regulations would create elaborate and highly costly compliance obligations for banking entities that are not engaged in proprietary trading or covered fund activities.

The proposed implementing regulations create a varied approach to implementing compliance with the regulations based on the level of proprietary trading activity of covered entities. First tier entities would be those not engaged in either proprietary trading or ownership/sponsorship of covered funds. Banking entities in the first compliance tier would be required to create and maintain a preventive compliance program. Essentially, a banking entity that is engaged in no proprietary trading would have to have both a program to prevent it from commencing prohibited activity and a compliance plan to cover it if it began to engage in prohibited activity. So, effectively, an entity in the first tier would likely be expected to adopt a compliance program similar to that of an entity engaged in prohibited trading. This is just one example of the overly burdensome approaches in the proposed implementing regulations.

BBVA Compass sees little or no value in adoption of burdensome and costly compliance policies designed merely to prove a bank is not engaged in proprietary trading and then to develop comprehensive policies and procedures in case the bank later engages in such activities.

Recommendation: Instead of requiring a costly new and burdensome compliance program, BBVA Compass advocates an approach whereby banks not engaged in proprietary trading or covered fund activity certify to their regulators that they are not engaged in activities prohibited by the Volcker Rule. Certification would be subject to the existing supervisory and enforcement process.

B. Compliance For Entities Engaged in Proprietary Trading

Under the agencies' proposed implementing regulations entities engaged in any level of permitted proprietary trading will be required to adopt a mandated compliance program but the obligations under the compliance program vary with the level of trading.

As proposed, banking entities engaged in limited proprietary trading (defined generally as trading assets and liabilities of less than $1 billion or less than 10% of total assets), would be in the second tier of compliance obligations. Banking entities in tier two would be required to have a compliance program that includes: written policies and procedures designed to document, describe and monitor trading activities; a system of internal controls designed to monitor and identify areas of noncompliance and to prevent occurrence of prohibited activities or investments; an appropriate management framework to create accountability for Volcker Rule compliance; independent testing of

the compliance program; training; and recordkeeping. Third tier entities, those engage in significant covered trading and covered fund activities (generally, covered trading or covered fund activity of $1 billion or more), would be required to comply with even more burdensome requirements.[1]

Recommendation: The compliance program and reporting requirements for tier three are extensive and highly prescriptive. Given what BBVA Compass believes to be marginal benefit of the proposed compliance program and reporting requirements, along with what will likely be significant costs of implementing them, we think the requirements for entities engaged in limited proprietary trading should be streamlined. Streamlining could be done without undermining the Volcker Rule. For example, if the tiered approach to compliance is retained, we recommend that the threshold for a tier three entity be raised to at least $10 billion. This would still cover U.S. banking organizations that control more than 97% of the total average trading assets and liabilities of all U.S. banking organizations.

II. Economic and International Implications

BBVA Compass is owned by BBVA, a financial services group headquartered in Spain with approximately $740 billion in total assets, 47 million clients, 7,400 branches and approximately 107,000 employees in more than 30 countries. As a wholly-owned subsidiary of BBVA, BBVA Compass can offer a unique perspective on the international implications of the Volcker Rule and we have significant concerns about the international implications of the Volcker Rule and its proposed implementing regulations.

A. Negative Economic Impact on the U.S.

We are concerned that the Volcker Rule's requirements relating to foreign banking organizations, as they are currently interpreted by the federal financial regulators, will have a negative impact on the U.S. economy without offsetting benefits to safety and soundness of U.S. banks. Our specific concern is that the standing of the U.S. as a financial services center, with a vast infrastructure that facilitates international transactions of all types, may be harmed by the unduly narrow interpretation by the federal financial regulators of the Volcker Rule provision addressing trading outside the U.S. by foreign banking organizations.

---

[1] A third tier entity would be one that:
(i) engages in proprietary trading and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters: (A) is equal to or greater than $1 billion; or (B) equals 10 percent or more of its total assets;
(ii) invests in, or has relationships with, a covered fund and: (A) the covered banking entity has, together with its affiliates and subsidiaries, aggregate investments in one or more covered funds, the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion; or (B) sponsors or advises, together with its affiliates and subsidiaries, one or more covered funds, the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion; or
(iii) is determined to be tier 3 base on regulator discretion.

The Volcker Rule was intended to protect U.S. banks and the U.S. economy. Consequently, the Volcker Rule permits foreign banking entities to engage in proprietary trading and covered funds activity solely outside the U.S. The apparent intent of the provisions allowing otherwise prohibited activity "solely outside" of the U.S. was to limit activities of an entity as principal. The provisions do not refer to the location of counterparties or exchanges. Accordingly, the Volcker Rule should only be interpreted to prevent trading activity if the principal is in the U.S. Nevertheless, the federal financial regulators have interpreted the Volcker Rule to prohibit foreign banks from conducting transactions with nearly any U.S. connection thereby preventing transactions with a U.S. counterparty or involving a U.S. exchange. We are concerned that the unduly narrow interpretation proposed by the federal financial regulators would shift trading from U.S. infrastructure to infrastructure of other financial service centers without increasing the safety and soundness of U.S. banks or otherwise benefitting the U.S. financial system. As a consequence, U.S. exchanges and U.S. customers would lose out as transactions shift to other financial service centers. We are also concerned that such a reduction in U.S. activity could also result in U.S. job losses and access to capital.

Recommendation: BBVA Compass does not believe that the Volcker Rule was intended to prohibit foreign banking organizations from using U.S. exchanges or engaging in transactions with U.S. counterparties.

B. Extraterritorial Compliance Obligations

As noted above, the proposed implementing regulations mandate detailed and prescriptive compliance requirements for banking entities engaged in permitted trading activities. Although the proposed implementing rules are not clear on this point, it appears that foreign banking entities engaged in such activities entirely outside of the U.S. would be subject to the compliance requirements. The proposed implementing regulations appear to propose that foreign banking organizations' proprietary or covered fund-related actions qualify as solely outside the U.S. and that such entities adhere to other subjective limitations as well as the compliance obligations discussed previously. We do not believe, and do not think Congress intended, that U.S. regulatory agencies should have authority to subject foreign banking entities operating pursuant to the laws of their home countries to requirements or supervision of U.S. regulators. To do so would be inconsistent with existing regulatory practice of deference to home country supervision and prudential regulation.

Recommendation: Federal financial regulators should not impose compliance program and reporting requirements outside of the U.S. To do so would impose heavy burdens on entities and activities already subject to the regulatory purview of other countries' regulators without providing any meaningful benefits to U.S. taxpayers or the U.S. financial system. The U.S. regulators' goals can be achieved by working more closely with foreign institutions' home country regulators by requesting information that will help the U.S. regulators monitor systemic risk while leaving regulators of foreign institutions to oversee banking activities in their country.

C. Non-U.S. Sovereign Securities

Notwithstanding the general prohibition on proprietary trading, the Volcker Rule also permits purchase, sale, acquisition or disposition of U.S. government securities but does not permit similar trading in non-U.S. sovereign securities. Trading in securities issued by foreign governmental entities is crucial to non-U.S. economies. Many U.S. and non-U.S. banks play a role in the purchase and sale of such government debt, and the market-making and other exemptions in the Volcker Rule may not be broad enough to ensure necessary levels of liquidity for non-U.S. government securities. This adverse impact on liquidity would increase financing costs for virtually every country but the U.S. Reducing liquidity in such markets or limiting the trading capabilities on such bonds seems likely to increase, rather than decrease, systemic risk.

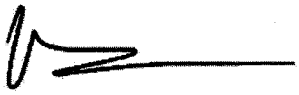
Finally, we note that any concerns about bank exposure to non-U.S. sovereign securities can best be addressed by revising rules dealing with the regulation of bank capital.

Recommendation: BBVA Compass advocates the creation of an exemption for non-U.S. government securities comparable to U.S. government securities.

* * *

As always, Mr. Chairman, we appreciate your leadership and stand ready to assist you and the Committee as you address the Volcker Rule and other important issues before you. Please contact either of the undersigned or Josh Denney in our Washington office (202-730-0952) if we can be of further assistance.

Very Truly Yours,



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Submitted for the Record Before the
Committee on Financial Services
United States House of Representatives

Hearing Entitled, "Examining the Impact of the
Volcker Rule on Markets, Business, Investors and
Job Creation, Part II"

2128 Rayburn House Office Building

Thursday, December 13, 2012

On behalf of the Bond Dealers of America ("BDA"), thank you for the opportunity to submit testimony for this hearing to examine the impact of the Volcker Rule on market participants. BDA represents middle market and regional banks and securities dealers focused on the US fixed income markets.

The BDA would like to underscore that the Volcker Rule implementation, if not carefully crafted, could harm liquidity in the fixed income markets. This testimony sets forth recommended solutions to avoid this outcome. Any final Volcker rule must permit bank-affiliated broker-dealers to continue their essential role of facilitating fixed income trading for their customers. If the Volcker Rule does not appropriately consider the uniqueness of fixed income markets and principal trading, costs to issuers financing critical public infrastructure will increase; and retail investors seeking low-risk investments will be harmed. Equally urgent and more fundamentally, the rule must exempt municipal revenue bonds in addition to governmental bonds. Finally, the Rule should clarify the underwriting activities exception and Tender Option Bond Trusts should be excluded from the definition of a covered fund.

The Volcker Rule Should Include An Exception for Principal Trading

The Volcker proposal exempts market making activities, but only if the "trading desk or other organizational unit that conducts the purchase or sale holds itself out as being willing to buy and sell...the covered financial position for its own account on a regular or continuous basis" (emphasis added). This exemption is too narrow and precludes the ability of bank-affiliated broker-dealers in the fixed income markets to facilitate trading among its customers. In order to support customer trading, a bank-affiliated broker-dealer must be permitted under the Rule to purchase a position for his or her own account until the broker is able to sell that position so that issuers have the assurance of a ready market for their bonds. A bank-affiliated broker-dealer cannot meet the test in the current proposal that requires it to hold itself out as continuously or regularly supporting specific positions; rather, the broker-dealer acts as a steady presence in the fixed-income markets to facilitate the customer trading by bridging buyers and sellers of bonds. Moreover, dealers support the markets by purchasing from other dealers, cooperating with each other to provide liquidity to the markets as a whole. If the market-maker exemption is too narrow and these activities are treated as proprietary trading, then an essential source of liquidity will be eliminated from the fixed-income markets, harming both issuers and investors.

The cure is to broaden the market-maker exemption to recognize the critical practice of "principal trading," in which bank-affiliated broker-dealers serve the role of facilitating trades for their customers. Because fixed income securities trade less frequently than equity securities, there may not be a buyer for a particular fixed income security at the precise point in time when a seller wants to sell it. Further, buyers tend not to target one specific security but will instead opt to purchase from a selection of bonds with characteristics meeting their investment objectives.

Therefore, the only way the fixed income markets work properly to match buyers and sellers is if broker-dealers are willing to purchase a bond into inventory with a view to re-sell that bond later to another customer.

Such principal trading is substantially different from the risk taking of proprietary trading. Since the purpose of principal trading is to facilitate customer trades, banks are incentivized to limit the risks of principal trading and, therefore, to institute policies and procedures that mitigate potential risks. At the same time, principal trading adds enormous value to ordinary investors by providing them a place to sell their bonds. This provides the liquidity and stability that makes the markets function.

BDA's recommendation is that the final Volcker Rule include in the market making exemption an additional exception that includes the purchases and sales of a "principal trading desk." A "principal trading desk" should be defined as having the purpose of facilitating trading among the bank's customers and clients. A safe harbor should be included in the definition based upon the presence of sales representatives in the desk's transactions. Essentially, BDA proposes that the Rule use the percentage of transactions a trading desk effects through sales representatives to determine when a trading desk clearly is -- and clearly is not -- a principal trading desk.

This approach would provide a method to prove that a bank's trading desk exists for the purpose of facilitating trading among customers that provides certainty to banks and regulators alike. Sales representatives trade with the customers and clients of the bank. Their presence largely implies the substantial involvement of the trading desk with customers. Sales representatives eliminate the incentive for banks to maintain "proprietary books" because trades involving sales representatives require the trading desk to pay a commission. Further, the involvement of sales representatives is easily provable since the trade tickets need to record the involvement of the sales representative in order to properly credit the sales representative for sales commissions.

Based on this certainty, BDA believes that the Agencies could create a safe harbor under which a trading desk would be deemed to be a principal trading desk if it effects more than 50% of its transactions through sales representatives. Conversely, the Agencies could deem a trading desk to "not be" a principal trading desk if it effects less than 25% of its transactions through sales representatives. While a principal trading operation with no "proprietary book" should ordinarily not experience trading activity with other broker-dealers that exceeds a majority of its trading activity, practices do vary. BDA recommends retaining the ability of a bank to establish that its principal trading desk is customer facing even if less than 50% (but more than 25%) of trades are through sales representatives, if other evidence can be produced to prove the customer-facing nature of the principal trading operations.

Providing more certainty to regulators, a trading desk (except for hedging transactions) could be required to make any covered financial position available for purchase to sales representatives through an electronic trading system if it is available to registered broker-dealers for purchase through an electronic trading system. The essence of a "proprietary book" is that its sales and trading inventory are not available for purchase by sales representatives. By making these covered financial positions available to both registered broker-dealers and sales representatives alike, it renders difficult any effort to maintain a "proprietary book" that effectively navigates the quantitative categories above.

These suggestions, if incorporated, would provide regulators and fixed-income dealers more of the certainty they need so that issuers and investors are not damaged by the issuance of a Volcker Rule that destroys the important role of principal trading within the fixed-income markets.

Municipal Securities Should Be Appropriately Defined and Exempted

The Volcker Rule, as currently proposed, recognizes that municipal securities are not the root cause of systemic risk and aims to exempt them from the prohibition on proprietary trading. The proposal, however, fails to exempt all state and local government securities – namely, those issued by agencies and authorities such as turnpike authorities and water and sewer districts. These issuances of municipal revenue bonds represent about 60% of the municipal securities market. They are indistinguishable from the 40% of municipal securities exempted from the proposed rule in that they do not present any more credit or systemic risk. The arbitrary distinction subjecting 60% of municipal securities to the Rule would interfere with the ability of broker-dealers to bridge gaps between buyers and sellers, immediately removing liquidity from the market that is necessary to keep issuance costs low and valuations stable. As the Securities and Exchange Commission ("SEC") and other agencies finalize the Volcker Rule, BDA urges the Agencies to exempt all state and local government securities from the proprietary trading prohibitions.

The Underwriting Activities Exception Should Be Clarified

While underwriting activities are exempt from the Volcker Rule, more clarity is needed around this proposed exception. Regional bond dealers can serve as underwriters for municipal issuers in which the dealer purchases the bond from the issuer in order to distribute and sell the bonds to investors. In the fixed-income markets, underwriters frequently underwrite bonds knowing that at the sale of the bonds, they may need to temporarily retain unsold allotments within their inventories -- particularly since liquidity in the fixed income markets is not as deep as other markets. The Rule should clarify that just because bonds temporarily remain within a bank-affiliated broker-dealer's inventory, this does not change the regulator's perception that the purchase or sale was performed in connection with a view to distribute the securities.

Tender Option Bond Trusts Should Be Excluded from the Definition of a Covered Fund

As now drafted, the proposed Volcker Rule would treat tender option bond trusts ("TOB Trusts") as "covered funds," the same as hedge funds and private equity funds, thereby prohibiting banks from using them as investments. TOB Trusts, however, should be excluded from the definition of a covered fund because they usually hold municipal securities. They operate as a more efficient way for state and local governments to access the capital markets and for banks to participate in the issuance and financing of tax-exempt bonds. Banks frequently sponsor TOB Trusts, may own residual and other ownership rights in TOB Trusts, and may provide credit and liquidity enhancements that support securities issued by TOB Trusts. If banks were required to divest their holdings in TOB Trusts, this could lead to a massive sell-off of municipal securities holdings that could destabilize the municipal securities markets.

The remedy is for the covered fund rules to borrow some of the principles of the proprietary trading rules of the proposed Volcker Rule. That is, if an asset is considered safe enough for a bank to purchase that asset directly under the proprietary trading rules, such as is the case with municipal securities, then there is no reason to prohibit a bank from creating a fund or trust to hold that asset indirectly.

Thank you for the opportunity to present our views on the proposed Volcker Rule. The Volcker Rule as proposed must be modified to better accommodate the nature of fixed income markets. Developing a definition of and exception around principal trading is a critical component of these modifications. BDA stands ready to assist the Committee as you continue your important review of the Rule.

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December 12, 2012

The Honorable Spencer Bachus
Chairman
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Bachus:

We appreciate the Committee's continuing focus on Section 619 of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank"), commonly known as the "Volcker Rule." In connection with tomorrow's hearing "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Part II," the Institute of International Bankers ("IIB") would like to reiterate our views on this important topic. As we have previously testified before the Committee, the IIB supports the goals of financial reform – namely, increased transparency; stronger capital and liquidity standards; and reduced risk to financial stability and to the taxpayer. At the same time, we have significant concerns regarding the negative effects on the U.S. and global economy if the Volcker Rule is implemented as currently proposed.

The IIB represents internationally headquartered financial institutions from over 35 countries around the world doing business in the United States. The IIB's members consist principally of international banks that operate branches and agencies, bank subsidiaries and broker-dealer subsidiaries in the United States. In the aggregate, our members' U.S. banking operations have more than $5 trillion in assets and provide 25% of all commercial and industrial bank loans made in this country and contribute to the depth and liquidity of U.S. financial markets. Our members also contribute more than $50 billion each year to the economies of major cities across the country in the form of employee compensation, contributions to local and national charities, tax payments to local, state and federal authorities, and other operating and capital expenditures.

At the outset, it must be recognized that, as with U.S. banks, the U.S. operations of international banks are subject to the same statutory limitations set forth in the Volcker Rule. Notwithstanding this fact, properly limiting its application outside of the United States is of key importance, and it is these issues to which we address our attention in this letter. Specifically, we have focused our comments on the cross border issues and potential extraterritorial effects

raised by the Volcker Rule that are of particular concern to internationally headquartered banks with U.S. banking operations ("international banks"), as well as to foreign governments and financial regulators.

Any consideration of the extraterritorial scope of the Volcker Rule must be guided by the fundamental policy underlying the Volcker Rule: the protection of U.S. banks, U.S. financial stability and U.S. taxpayer funds from what Congress deems to be inappropriate risks. Simply put, there is no justification for the Volcker Rule to limit transactions by international banks that do not put U.S. financial stability, the safety and soundness of U.S. banks or U.S. taxpayer dollars at risk. Inappropriately imposing U.S. limitations outside the United States would have significant adverse and unintended consequences for international banks, as well as the U.S. economy and U.S. investors. The flow of capital from foreign investors to U.S. companies would be restricted, and liquidity in U.S. markets would be reduced, without any corresponding benefit to U.S. financial stability, U.S. taxpayers or the safety and soundness of U.S. banks.

While, as noted above, the U.S. operations of international banks are subject to the Volcker Rule to the same degree as U.S.-headquartered banks, Congress has already properly sought to limit the extra-territorial impact of the Volcker Rule by providing exemptions for certain activities conducted "solely outside of the United States" (the "SOTUS" exemptions). By providing this exemption, Congress recognized that if it were to do otherwise and regulate the trading practices of international banks and their non-U.S. affiliates, it would create unwarranted conflicts with foreign regulation and needlessly divert scarce U.S. regulatory resources to matters that do not implicate U.S. financial stability, the safety and soundness of U.S. banks or U.S. taxpayers.

The proposed rules layer on additional limitations that make the exemptions too narrow, cutting off trade with U.S. investors and on U.S. exchanges without any corresponding benefit for U.S. financial stability. For example, under the proposed rules, a trade between a German bank in Frankfurt and a UK bank in London would apparently not qualify for the SOTUS exemptions if it were executed on a U.S. exchange. Similarly, a trade between a French bank and a U.S. manufacturing firm over a European trading platform would apparently subject the French bank to the full panoply of regulations under the proposed rules by virtue of having traded as principal with a single U.S. person.

Similarly, while the Volcker Rule quite appropriately recognizes that U.S. publicly-traded mutual funds should not be subject to the Volcker Rule's funds prohibition, no similar recognition is given to comparable foreign investment companies, including funds that engage in public offerings outside of the U.S. For example, regulated investment funds in Canada could not be offered or sold by Canadian banks to Canadian residents while traveling on business or pleasure in the U.S.

If the proposed rules' restrictions on permissible non-U.S. trading and funds activities are retained, they will reduce liquidity in U.S. markets and securities, contribute to the migration of trading and fund activities to other financial centers outside of the United States and spur the

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development of alternative trading platforms outside of the United States, all of which are likely to cause job losses in the United States. This loss of jobs would come without any offsetting reduction in the risk to U.S. financial markets, U.S. taxpayers or the safety and soundness of U.S. banks.

Trading in non-U.S. government securities also should benefit from the same exemption from the proprietary trading prohibition as U.S. government securities. Liquidity in sovereign debt markets is vital to the functioning of national economies around the world. In light of the unique importance of trading in government securities, both to sovereigns and to the treasury activities of banks in the jurisdictions where they operate, all government securities should be excluded from the Volcker Rule. Providing an exemption only for U.S. government securities would also be inconsistent with U.S. treaty obligations and principles of national treatment.

Other regulatory frameworks (such as capital regulation) and supervisory authority provide more appropriate and flexible mechanisms for addressing any concerns regarding bank exposure to sovereign debt. The Volcker Rule is simply too blunt an instrument to address the many policy considerations and unique features of trading in government securities.

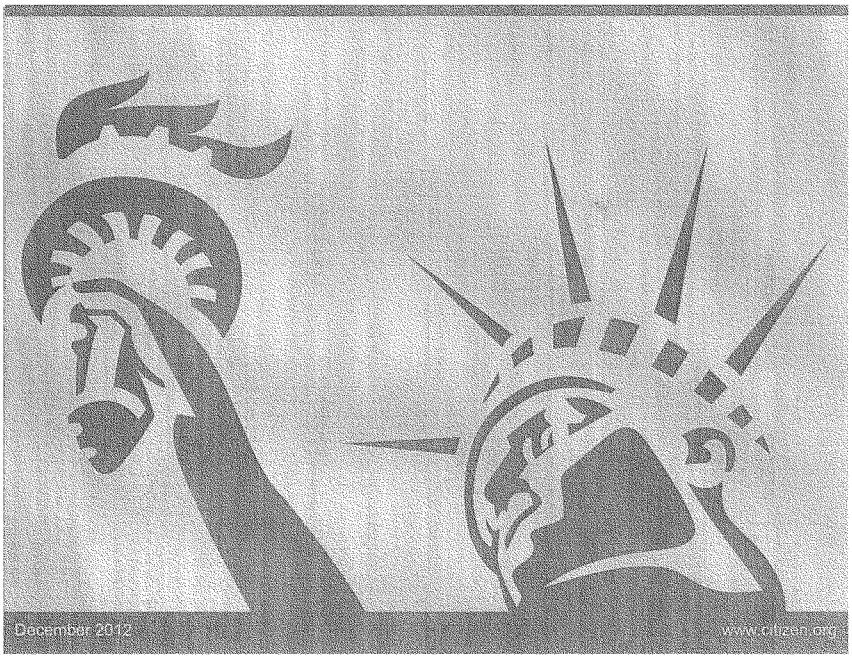
In addition to the foregoing, in order to give those entities impacted by the Volcker Rule sufficient time to come into compliance with its requirements, it is imperative that the affected institutions be provided a two-year time period commencing with the issuance of final regulations.

Thank you for considering our views.

Sincerely,

Sarah A. Miller
Chief Executive Officer

cc: The Honorable Barney Frank



Business as Usual

99.9 Percent of Banks Would Be Unaffected by Volcker Rule

Acknowledgments

This report was written by Bartlett Naylor, Financial Policy Advocate for Public Citizen's Congress Watch division, and edited by Taylor Lincoln, Research Director for Congress Watch.

About Public Citizen

Public Citizen is a national non-profit organization with more than 300,000 members and supporters. We represent consumer interests through lobbying, litigation, administrative advocacy, research, and public education on a broad range of issues including consumer rights in the marketplace, product safety, financial regulation, worker safety, safe and affordable health care, campaign finance reform and government ethics, fair trade, climate change, and corporate and government accountability.

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**For Congressman Brad Miller of North Carolina
Whose service to America as a brilliant, loyal protector of average citizens in the U.S. House of Representatives will be missed**

Contents

I. INTRODUCTION: THE RIDE OF THE VOLCKER RULE, CAN BANKS LIVE WITH IT? 5

II. THE RISE OF CASINO BANKING 6

III. THREE CASE STUDIES: SAFE AT ANY SIZE 8

IT'S A WONDERFUL LIFE: GENERATIONS BANK 8

SWEET SPOT OF EFFICIENCY: M & T BANK 11

WELLS FARGO: OLD SCHOOL BANKING 12

IV. CONCLUSION: CLOSING THE CASINO 16

I. Introduction: The Ride of the Volcker Rule Can Banks Live with It?

There are 7,181 federally insured banks in the United States.[1] After a new rule is implemented to prohibit banks from making risky trades, the business activities of 7,175 of these banks will remain essentially unchanged.

The Volcker Rule, among the most controversial aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act, will prohibit federally insured banks from engaging in proprietary trading, which involves speculation through short-term trades in stocks, derivatives and other securities.[2]

The financial crash, borne of reckless banking practices, cost the economy about $12 trillion, give or take.[3] But Wall Street lobbyists have succeeded in elevating concerns over the relatively minuscule costs of the Volcker Rule to a paramount position in the debate over how regulations should be crafted to implement it. In reality, the Volcker Rule will mean no change, no closure of business divisions, no costs from foregone financial activity, for more than 99.9 percent of banks.

What follows is an examination of how American banks will adapt to the Volcker Rule. We review three banks—one small, one medium-sized, and one giant—as case studies. This report examines the details of these banks' revenue and earnings, how the Volcker rule might alter them, and how the managers of some of the banks evaluate the effect that the rule will have on them.

The nation's banking regulators are entering the last stages of finalizing the Volcker Rule this month, long after the July 21, 2012, deadline for completion imposed by Congress in Dodd-Frank. In all, 21 individuals nominated by the president and confirmed by the U.S. Senate (serving at the Federal Reserve, Federal Deposit Insurance Corp., Office of the Comptroller of the Currency, Commodity Futures Trading Commission, or Securities and Exchange Commission) must agree to the precise language of this rule. While the regulators undoubtedly understand the impact of the financial crisis, they will inevitably consider the effects on the industry they regulate. These regulators have conducted 4,000 meetings with

[1] FDIC, *Statistics at a Glance* (Sept.) 12, 2012), available at: http://www.fdic.gov/bank/statistical/stats/2012sep/industry.pdf These institutions include commercial banks as well as federally insured savings and loan institutions. It does not include the 6,888 federally insured credit unions; none of these institutions engage in Volcker Rule-prohibited activity.
[2] The Volcker Rule is the informal name for Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Federal officials at present are finalizing the rules, or regulations, to implement Section 619.
[3] *See, e.g.,, Cost of the Crisis*, BETTER MARKETS (Fall 2012), available at: http://www.bettermarkets.com/cost-crisis#.UMYFZdSUrl4

outsiders, the overwhelming majority of which have been Wall Street representatives.[4] But these regulators must understand that the banking industry will thrive with a robust Volcker Rule.

II. The Rise of Casino Banking

The lure of astronomical profits from proprietary trading prompted a select group of large banks to deviate from sensible risk management practices. This sober account from the Group of 30, a non-profit international group consisting of private sector and academic leaders on financial issues,[5] recalls how the industry succumbed to a gambling ethos:

> Recent experience in the United States and elsewhere has demonstrated instances in which unanticipated and unsustainably large losses in proprietary trading, heavy exposure to structured credit products and credit default swaps, and sponsorship of hedge funds have placed at risk the viability of the entire enterprise ... These activities, and the "originate-to-distribute" model, which facilitated selling and reselling highly engineered packages of consolidated loans, are for the most part of relatively recent origin. In essence, these activities all step away from the general concept of relationship banking, resting on individual customer service, toward a more impersonal capital markets transaction-oriented financial system. What is at issue is the extent to which these approaches can sensibly be combined in a single institution, and particularly in those highly protected banking institutions at the core of the financial system.[6]

Concerns over the activities outlined above prompted Congress to institute the Volcker Rule—informally named after Group of 30 member and former Federal Reserve Chairman Paul Volcker—to prohibit federally insured banks from engaging in proprietary trading or owning hedge funds of more than *de minimis* size. Opponents and proponents alike commonly observe that this provision promises the greatest change in American banking since the enactment in 1933 of the Glass-Steagall Act, which separated of commercial and investment banking.

In principle, the Volcker Rule aims to protect banking's core function of aggregating savings so that savings can be deployed in loans to consumers, homebuyers, and businesses. Federal deposit insurance protects the savers, which encourages them to accept lower returns (in this case, in the form of interest rates) than they would expect for higher-risk investments. Banks, in turn, are expected to pass on savings from their reduced cost of

[4] Davis-Polk, *Dodd-Frank Progress Report* (November 2012), available at: http://www.davispolk.com/files/Publication/9a990de9-911b-4e6b-b183-08b071d8b008/Presentation/PublicationAttachment/8363256a-524d-4d65-8ebe-096127dab2a3/Nov2012_Dodd.Frank.Progress.Report.pdf.

[5] *See* Group of 30 Web site, available at: http://www.group30.org/about.shtml.

[6] *Financial Reform, a Framework for Financial Stability, Group of Thirty* (Jan. 15, 2009), available at: http://www.group30.org/images/PDF/Financial_Reform-A_Framework_for_Financial_Stability.pdf.

capital to their borrowers. The benefits that accrue from reduced costs of capital justify expectations that the banks abstain from high-risk activities.

The Independent Community Bankers of America (ICBA), consisting of more than 5,000 member banks,[7] articulated this view in a comment letter it submitted to federal regulators on the proposed regulations to implement the Volcker Rule: "Banks are accorded access to federal deposit insurance and liquidity facilities because they serve a public purpose: facilitating economic growth by intermediating between savers and borrowers, *i.e.*, taking deposits and making loans, and by maintaining liquidity in the economy throughout the economic cycle. These activities constitute the fundamental business of banking."[8]

By its nature, a proprietary trade is a bet—a gamble. For every winner, there is a loser. A bank's gain from a proprietary trade results in a corresponding loss for the counterparty. No factories are financed, homes mortgaged, or cars purchased as a result of gambles won or lost by banks engaged in proprietary trading.

Gambling can generate profits for institutions. Last decade, traders and bank managers pocketed mind-boggling sums in exchange for presiding over successful betting strategies. But when the traders' bets turned sour, wiping out the earlier gains and forcing their institutions to accept massive taxpayer-financed bailouts, the bankers retained the fortunes they had reaped in the previous years. Protecting the ability of bank executives and traders to command such bounties is a key reason that certain Wall Street leaders have intensely contested the Volcker Rule. The debate over the Volcker Rule has arguably been the subject of more lobbying expenditures, regulatory meetings, congressional meetings, formally commissioned studies, and media coverage than any other regulation called for in Dodd-Frank.

Public Citizen documented the scope of industry's obsession of the Volcker Rule earlier this year.[9] Wall Street interests contributed $67 million to the campaigns of members of Congress who asked regulators to weaken the proposed regulations to implement the Volcker Rule. By contrast, members of Congress who pressed for a stronger regulations received a collective $1.9 million from Wall Street donors. However, a crucial fact is: More than 99.9 percent of banks' circumstances won't change because of the Volcker Rule. This rule is important to prevent a fraction of 1 percent of banks from putting our financial system—and, ultimately, our economy—at risk.

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[7] ICBA Web site, *About Us*, available at: http://www.icba.org/aboutICBA/index.cfm?ItemNumber=527.
[8] ICBA comment letter on the Volcker Rule (Feb. 13, 2012), available at: http://www.federalreserve.gov/SECRS/2012/March/20120305/R-1432/R-1432_021312_104966_451638070183_1.pdf.
[9] NEGAH MOUZOON AND BARTLETT NAYLOR, PUBLIC CITIZEN, *Industry's Messengers* (March 2012), available at: http://www.citizen.org/documents/industrys-messengers-volcker-rule-report.pdf.

There are 7,181 banks in the United States. Of these, six account for 88 percent of all proprietary trading affected by the Volcker Rule.[10] Four banks account for 93 percent of total derivatives holdings, a major venue in proprietary trading.[11] "Proprietary trading in any real volume is confined to a very few large, sophisticated U.S. banks," Volcker wrote in a letter to federal regulators.[12] The nation's 6,888 credit unions are legally barred from using derivatives.[13] In other words, of the 14,069 institutions that the average consumer would consider a "bank," the Volcker Rule means business as usual for 14,063 of them.

It should be noted that banks do maintain investment accounts consisting of easily sellable securities, and will be able to continue doing so after the Volcker Rule takes effect. "Trading accounts," which may include U.S. Treasuries, corporate stocks and other securities, help banks meet unexpected cash demands, such as an unusual surge in withdrawals. Managers of trading accounts typical invest in conservative securities and retain their investments for a longer time than do proprietary traders. Under the Volcker Rule, trading accounts may not be a playground for short-term speculation.

III. Three Case Studies: Safe at any Size

The banking industry is composed of firms of various sizes, ranging from banks with only a single store front, to mid-sized regional firms, to a handful of mega-banks. How will the Volcker Rule apply, based on bank size? Examined here are three case studies: A smaller bank, Generations Bank of Seneca Falls, N.Y.; a mid-size bank, M&T Bancorp, of Buffalo, N.Y.; and a mega-bank, Wells Fargo Bancorp, headquartered in San Francisco.

It's a Wonderful Life: Generations Bank

In the heartland of America, largely served by community bankers, the type of activity targeted by the Volcker Rule is unknown.

One of the 7,181 American banks that will not be unaffected by the Volcker Rule is Generations Bank, of Seneca Falls, N.Y.

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[10] GOVERNMENT ACCOUNTABILITY OFFICE, *Proprietary Trading* (July 2011), available at: http://www.gao.gov/assets/330/321006.pdf.

[11] U.S. Comptroller of the Currency, *OCC's Quarterly Report on Bank Trading and Derivatives Activities Second Quarter 2012*, available at: http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq212.pdf.

[12] Paul Volcker, letter to regulators (Feb. 13, 2012), available at: http://www.sec.gov/comments/s7-41-11/s74111-182.pdf.

[13] GOVERNMENT ACCOUNTABILITY OFFICE, *Proprietary Trading*, at 64 (July 2011), available at: http://www.gao.gov/assets/330/321006.pdf. The credit union industry is lobbying to remove restrictions on derivative use. For example, here is a letter from the Credit Union National Association from April 3, 2012: http://www.ncua.gov/Legal/CommentLetters/CL20120403DunnDerivatives.pdf.

"It's a Wonderful Life," Frank Capra's iconic Hollywood film about the travails of a small town banker, is set in mythical "Bedford Falls." Seneca Falls claims to be Frank Capra's inspiration. This real "Bedford Falls" features a museum dedicated to the film, and an annual "It's a Wonderful Life" festival. The Clarence Hotel was named in honor of the angel Clarence who talks banker George Bailey off the bridge of despair by reviewing the virtues of traditional banking. This year, the actress who played the daughter of the beleaguered banker joined the December festival.[14]

Generations Bank, headquartered in Seneca Falls, founded in 1870, fits the description of George Bailey's bank to a tee: Folks in the community deposit their savings ($193 million) in one of the bank's nine branches, and then the bank loans out this money in mortgages to home buyers, in loans to car buyers, and credit to small business ($190 million).[15]

The bank has reported rising net income: $476,000 in 2009, $1.1 million in 2010, and $1.3 million in 2011. Through nine months of 2012, the bank reported $1.2 million in income.[16]

Generations Bank has transformed, at least in name, over the 14 decades since its founding in 1870 as Seneca Falls Savings Bank.[17] Before the financial crash of 2008, the institution was called Seneca-Cayuga Bancorp. With the acquisition of other banks, the firm adopted Generations Bank as its umbrella name. CEO Menzo Case is the bank's largest single shareholder.[18]

The Volcker Rule will result in no substantial change of operations for Generations Bank. none of the bank's 85 employees are derivatives traders. None engage in market making or risky gambles. Generations Bank does hold some securities, in addition to its loans. In 2009, for example, the bank held $1.7 million worth of securities, and earned a total of $1,000 from trades involving them.[19] Because of the minimal nature of its trading, Generations will not be subject to reporting requirements of the Volcker rule will require of larger banks.

[14] Web site for Seneca Falls town festival. Available at: http://www.therealbedfordfalls.com/.
[15] Generations Bank, Third quarter report, 2012. Available at: https://www.mygenbank.com/files/financial_filings/quarterly_reports/2012_3.pdf.
[16] *Id.*
[17] Generations Bank, Annual Report, 2009, available at: https://www.mygenbank.com/files/financial_filings/annual_reports/2009_annual_report.pdf.
[18] Generations Bank, Annual Report, 2010, available at: https://www.mygenbank.com/files/financial_filings/annual_reports/2010_annual_report.pdf.
[19] This was the last year the company reported its trading activity; it deregistered as a public company after that.

What Is the Ideal Size for a Bank?

How do banks perform based on size? While iconic, community banks lack the economies of scale enjoyed by larger banks. But the largest banks, others contend, may be unwieldy or difficult to manage. Is there a sweet spot in size? The field of industrial organization applies sophisticated metrics to examine the issue of the ideal size of a bank. This field of study figures into current issues about ideal bank size, evidenced by a December 4, 2012, speech by Federal Reserve Gov. Daniel Tarullo.[20]

The simplest measure of efficiency is the ratio of expenses to revenue. How much does each dollar of revenue cost a bank to generate? A bank that generates $1 in revenue with 45 cents in expenses is more efficient than the bank that generates $2 in revenue with $1 in expense. The former can generate a greater profit for its shareholders. The more efficient bank may be better for consumers, as it is better positioned to provide greater customer value in competition with its less efficient competitor.

As it happens, small banks dominate the list of "most efficient" banks. While rankings change with each quarterly report, *American Banker* routinely shows that banks with less than $5 billion in assets command the lion's share of "top 200" most efficient banks. In its most recent report, *American Banker* found that the top 10 most efficient banks all managed assets of less than $3.3 billion, and most managed less than $2 billion. U.S. Bancorp made this "top 200" list with an efficiency rating of 52 percent, placing it 89th on the list. U.S. Bancorp lists assets of $340 billion. Two other banks with more than $100 billion also made this efficiency list: BB&T Corp., with $174 billion, ranked 173rd; and Fifth Third Bancorp, with $116 billion, ranked 177th.

"No one can find such efficiency enhancements for banks with more than $100 billion in total assets," according to MIT economist Simon Johnson.[21]

[20] Speech by Gov. Daniel Tarullo at Brookings Institution, *Industry Structure and Systemic Risk Regulation* (Dec. 4, 2012), available at: http://www.federalreserve.gov/newsevents/speech/tarullo20121204a.htm.
[21] Simon Johnson, *Why Are the Big Banks Suddenly Afraid*, THE NEW YORK TIMES (Aug. 30, 2012), available at: http://economix.blogs.nytimes.com/2012/08/30/why-are-the-big-banks-suddenly-afraid/. Identifying the sweet spot for efficiency and economies of scale has been compromised by vast changes in banking law. First, banks were allowed to branch across state lines only in the last three decades. Second, their powers were expanded, ultimately allowing the kinds of activity that the Volcker Rule will prohibit. Finally, major financial catastrophes cloud conclusions. Risky trading may have figured in the 2008 crash, but that led to problems at less culpable banks in the form of cascading housing prices and mortgage values.

"We have an [asset liability management] committee that reviews our position monthly, which includes consideration of whether we should purchase additional securities," Case explained. "If securities are to be purchased, either myself or the CFO will make the purchase."[22] Generations devotes one employee to compliance.

"Our Company has a history of conservative risk management—we don't 'reach' for yield by entering into areas that we do not understand or for which the risk is not understood," Case wrote to shareholders.[23] "I have yet to find an NY community bank that is actively trading securities. It's just not the way we operate," he wrote in e-mail to Public Citizen.[24]

Sweet Spot of Efficiency: M & T Bank

Will larger banks find their business undermined by the Volcker Rule? An examination of M&T Bank, the nation's 31st largest with $77 billion in assets,[25] shows that the Volcker Rule will cause no change to the bank's operations. M&T Bank believes it will continue to thrive. Its efficiency ratio in the first quarter of 2011 ranked 83rd of the nation 6,900 bank holding companies on the *American Banker* list.[26]

"Based on the proposed rules, M&T does not currently anticipate that the Volcker Rule will have a material effect on the operations of M&T and its subsidiaries," the bank informed shareholders.[27]

Founded in 1856 in western New York, the Buffalo-headquartered bank maintains 750 branches in eight states and the District of Columbia.

M&T employs 15,666 people, up from 13,869 in 2007 before the financial crash. M&T has grown by making acquisitions. Its largest acquisition, coincidentally, followed a proprietary trading fiasco at Allied Irish Bank's Baltimore-based division.[28] Since the financial crash of 2008, M&T has purchased Provident Bank of Baltimore, the failed Bradford Bank (seized by

[22] Menzo Case, CEO, Generations Bank, e-mail response to Public Citizen questions (Nov. 16, 2012). On file with author.
[23] Generations Bank, Annual Report, 2010, available at: https://www.mygenbank.com/files/financial_filings/annual_reports/2010_annual_report.pdf.
[24] Menzo Case, CEO, Generations Bank, e-mail response to Public Citizen questions (Nov. 16, 2012). On file with author
[25] *Banks and Thrifts with the Most Assets*, AMERICAN BANKER (Second quarter 2012).
[26] *Most Efficient Banks*, AMERICAN BANKER (First quarter 2011).
[27] M&T Bank, Annual Report, 2011, available at: http://files.shareholder.com/downloads/MTB/2107851053x0x546897/5C592DA0-5A87-4F46-8AF6-8639E1B8963E/2011_Annual_Report.pdf.
[28] *See* Conor O'clery, PANIC AT THE BANK (2002).

the FDIC), Wilmington Trust, and Hudson City Bancorp. Berkshire Hathaway is its largest shareholder, owning 5.6 percent of its stock.[29]

M&T has reported a profit in every quarter since 1970. Net income increased from $380 million in 2009 to $736 million in 2010, and $859 million in 2011.[30]

M&T reported $27 million in trading account gains in 2011, in line with gains of $17 million to $30 million from 2007 to 2010.[31] Its trading profits represented 3 percent of its net income in 2011.[32]

M&T did report a "gain on bank investment securities" of $150 million in 2011 that was not pursuant to its trading account. The bank explained that this stemmed from an agreement to boost its capital following its acquisition of Wilmington Trust. It booked the gain by selling slightly riskier securities, and then purchasing less risky securities. Capital, or the amount of investor funds in the bank, is measured against the relative risk of its assets. These assets include loans and securities. By holding less risky securities, its capital measure is considered stronger.[33]

The fact that M&T derives only 0.6 percent of its total income from trading reflects a conscious decision by the bank's leadership. CEO Robert Wilmers reported to shareholders: "Banks have traditionally played a clear, if limited, role in the economy: to gather savings and to finance industry and commerce. Trading and speculation were nowhere included—nor should they be."[34]

Of his larger peers that engage in proprietary trading, Wilmers expresses little sympathy. "The Wall Street banks continue to fight against regulation that would limit their capacity to trade for their own accounts—while enjoying the backing of deposit insurance—and thus seek to keep in place a system which puts taxpayers at high risk."[35]

Wells Fargo: Old School Banking

While the Volcker Rule essentially applies to only the largest banks with dedicated staff handling its trading account, mega-banks can remain large and profitable under the forthcoming restrictions on proprietary trading and hedge fund ownership. Wells Fargo proves this.

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[29] M&T Bank, Annual Report, 2011, available at: http://files.shareholder.com/downloads/MTB/2107851053x0x546897/5C592DA0-5A87-4F46-8AF6-8639E1B8963E/2011_Annual_Report.pdf.
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Id.*

Of the nation's 7,394 commercial banks, four institutions stand out in size: JP Morgan Chase, Bank of America, Citicorp, and Wells Fargo. Each of these banks holds roughly $1 trillion in deposits, ranging from $906 billion at Wells Fargo to $1.1 trillion at JP Morgan.[36] Together, they account for nearly half of the nation's $9 trillion in total deposits.[37] (The fifth largest depository is U.S. Bancorp, which holds $233 billion in deposits, about a fifth of the next largest.[38]) In the basic intermediation of savers and borrowers, these large four banks control about half of all deposits. How they deploy these dollars shapes the economy. Even a small diversion into proprietary trading of depositor savings is the equivalent to a wholesale decision by Generations, M&T, and hundreds of other like-sized banks to allocate all of their deposits to proprietary trading.

Government Report Says Proprietary Trading Is Not a Winner for Big Banks

Congress required the Government Accountability Office to study the role of proprietary trading at the largest banks. In July 2011, the GAO concluded that even at the six major banks, proprietary trading did not generate consistent profits. The researchers examined the 13 quarters from 2006 to 2010, before, during, and after the financial crash. While the firms collectively posted occasional winnings, they also suffered substantial losses. Proprietary trading resulted "in an overall loss from such activities over the 4.5 year period of about $221 million," the government researchers concluded.[39]

Citicorp and Bank of America received considerable taxpayer bailouts. Meanwhile, government leaders such as former FDIC chair Sheila Bair and even President Obama have called for the closure of one or both of these institutions.

Citigroup does not object to the Volcker Rule. For example, in Citigroup's relatively brief 10-page comment letter on the proposed rule to federal regulators, the firm states: "We stand firmly behind the Volcker Rule's core principles of re-focusing trading businesses on the needs of customers and markets, while reducing potential risk to financial institutions and our financial system."[40] No representatives of Citigroup or Bank of America have testified in any of the congressional hearings on the Volcker Rule in the 112th Congress. In

[36] Research by SNL Advisers, available at: http://www.snl.com/InteractiveX/Article.aspx?cdid=A-15031738-14889.
[37] Federal Reserve statistics (Nov 7, 2012). Available at: http://www.federalreserve.gov/releases/h8/current/.
[38] Research by SNL Advisers, available at: http://www.snl.com/InteractiveX/Article.aspx?cdid=A-15031738-14889.
[39] GOVERNMENT ACCOUNTABILITY OFFICE, PROPRIETARY TRADING (July 2011), available at: http://www.gao.gov/assets/330/321006.pdf.
[40] Letter from Brian Leach, chief risk officer, Citigroup (Feb. 13, 2012), available at: http://www.federalreserve.gov/SECRS/2012/March/20120307/R-1432/R-1432_021312_104979_542079506624_1.pdf.

fact, former Citi Chairman John Reed counts as one of the Volcker Rule's earliest and most outspoken supporters. [41]

JP Morgan's opposition to the Volcker Rule is well known. The firm's proprietary trading became infamous in the spring of 2012 when it revealed a $5 billion to $7 billion loss from self-described "egregious" trades in London.

And Wells Fargo?

The name Wells Fargo derives from the 1850s entrepreneurs who profited from the traffic generated by the California gold rush. The bank itself served as a side business to the freight enterprise. Today's Wells Fargo is more accurately understood as Norwest Bank, a Minnesota branch-bank network, which bought the more familiar San Francisco-based Wells Fargo in 1998.[42] Norwest senior management has served in the top positions of Wells Fargo since the merger.

Of the largest four American banks, Wells Fargo's business is decidedly old school. Summarized a *New York Times* columnist, "It focuses on plain-vanilla lending like mortgages, credit cards and corporate loans, and ... emerged relatively unscathed from the financial crisis."[43] Wells Fargo boasts a high rating for its own debt.[44]

Will the Volcker Rule undermine this San Francisco-based giant's prospects? Proprietary trading generated the firm $2 million in profits in the third quarter of 2012, and $16 million over the first nine months of the year.[45] The $2 million in income represented 0.04 percent of the Wells' $4.94 billion in net income. [46] Proprietary trading accounted for a $9 million loss in the third quarter of 2011, and an $18 million loss for the first nine months of 2011. Proprietary trading, concluded Wells Fargo CEO John Stumpf, is "almost zero for us."[47]

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[41] Letter from John Reed to federal regulators (Feb. 13, 2012), available at: http://www.federalreserve.gov/SECRS/2012/March/20120301/R-1432/R-1432_021312_105359_329619421677_1.pdf.
[42] Wells Fargo annual report, 2000, available at: http://sec.gov/Archives/edgar/data/72971/0000912057-00-012168.txt.
[43] Peter Eavis, *Banks Tread a Fine Line in Trading*, THE NEW YORK TIMES (May 13, 2012), available at: http://dealbook.nytimes.com/2012/05/13/banks-tread-a-fine-line-in-trading/
[44] Wells Fargo Web site: https://www.wellsfargo.com/invest_relations/debt/.
[45] Wells Fargo quarterly report, third quarter 2012, available at https://www.wellsfargo.com/downloads/pdf/invest_relations/3Q12_10Q.pdf.
[46] Wells Fargo quarterly report, third quarter 2012, available at https://www.wellsfargo.com/downloads/pdf/invest_relations/3Q12_10Q.pdf.
[47] *Wells Fargo's Stumpf on the Volcker Rule*, CNBC (Feb. 17, 2012), available at: http://video.cnbc.com/gallery/?video=3000073921.

The firm does engage in market-making, which the proposed Volcker Rule will allow. (Market making involves trading activities in which the bank aims to profit through commissions rather than through changing values of the underlying investments.) "We make active markets in more than 400 issues and are recognized as a top 10 trader in convertible bonds," Wells Fargo says on its Web site.[48]

Berkshire Hathaway—run by Warren Buffett, the nation's second wealthiest person,[49] and Charles Munger—holds nearly 10 percent of Wells Fargo's stock,[50] accounting for nearly 20 percent of the value of Berkshire Hathaway's investment portfolio.[51] On why Berkshire Hathaway and others might find Wells Fargo "so attractive," *Forbes* observed: "Well, Wells Fargo is distinctive for what it doesn't do: rely on proprietary trading."[52]

The one way the Volcker Rule could impact Wells Fargo is through the law's ban on hedge fund ownership. Wells Fargo fears federal regulators might bar its venture capital and merchant banking subsidiaries under the Volcker Rule. The funds largely fall under the name of Norwest, such as Norwest Equity Partners, Norwest Venture Partners, etc. [53] Wells Fargo lists 1,207 separate subsidiaries. [54]

Wells Fargo does not explicitly report the results of its venture and merchant capital subsidiaries. It does report various investment gains. In the latest quarter, Wells Fargo reported a gain of $167 million from the sale of debt and equity securities. That represented 1.5 percent of its total $10.5 billion in non-interest income, and 0.6 percent of its total interest and non-interest income of $21.5 billion for the quarter. Income from these sales represented 3.3 percent of its net income.[55]

Despite the apparent lack of significance of Volcker Rule-prohibited activity for Wells Fargo and CEO Stumpf's dismissal of the importance of proprietary trading, Wells Fargo has joined the vigorous industry effort to contest robust implementation. The firm penned two

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[48] This assertion appears in the promotional material of a Wells Fargo Web site, available at: https://www.wellsfargo.com/com/securities/equity-sales.
[49] *See* FORBES (Sept. 19, 2012), available at: http://www.forbes.com/forbes-400/.
[50] Wells Fargo, proxy statement 2012, http://sec.gov/Archives/edgar/data/72971/000119312512117239/d285202ddef14a.htm.
[51] *Buffett How Has 19.4% of Portfolio in Wells Fargo: Why it's the Better Bank Stock*, FORBES (Nov. 25, 2012), http://www.forbes.com/sites/ycharts/2012/11/25/buffett-how-has-19-4-of-portfolio-in-wells-fargo-why-its-the-better-bank-stock/.
[52] *Id.* Buffett discusses the Volcker Rule in this video: Buffett on Volcker rule: http://www.valuewalk.com/2012/05/warren-buffett-talks-about-volcker-rule-video/.
[53] Wells Fargo exhibit to annual report, 2012, available at: http://sec.gov/Archives/edgar/data/72971/000119312512084528/d280360dex21.htm.
[54] *Id.*
[55] Wells Fargo quarterly report, third quarter 2012, available at https://www.wellsfargo.com/downloads/pdf/invest_relations/3Q12_10Q.pdf.

letters to the federal agencies, and joined in endorsement of two others.[56] Instead of a rule, Wells Fargo asks for special treatment: "We believe that a better approach would be to allow each covered banking entity to work with its primary federal regulator to tailor more general rules applicable to each covered banking entity and its unique trading attributes."[57]

The Volcker Rule should portend minimal change for the company's business. Further, Wells Fargo's largest shareholder may be impatient with any attempts by management to violate the Volcker Rule. Berkshire Hathaway's Munger commented, "Take the rapid trading by the computer geniuses [responsible for proprietary trading at banks]. Those people have all the social utility of a bunch of rats admitted to a grainery. I never would have allowed the rats to get in the grainery. I don't want the brilliant young men of America being rats in somebody else's grainery."[58]

IV. Conclusion: Closing the Casino

While large bank lobbyists and others who profit from bank proprietary trading vocally oppose the Volcker Rule, Washington representatives of the vast majority of American banks endorse this reform. The Independent Community Bankers of America boasts 5,000 members among the nation's 7,181 banks.[59] While Wall Street lobbyists forecast grave harms from the Volcker Rule, here's what the trade association for the lion's share of the banking industry concludes: "ICBA generally supports the Volcker Rule, which is an important step toward protecting the business of banking from the speculation inherent in proprietary trading and sponsoring or investing in hedge funds."[60] The trade association explains: "The recent financial crisis and the ensuing government bailout show what happens when banks depart from the fundamental business of banking."[61]

If the Volcker Rule affects relatively few players on Wall Street, why the storm and fury? M&T Bank CEO Wilmers speculates that personal compensation figures at the center of this public controversy, and that compensation undermines public perception of the social utility of banking. "Public cynicism about the major banks has been further reinforced by the salaries of their top executives, in large part fueled not by lending but by trading. At a

[56] Compilation of all letters to Federal Reserve on Volcker Rule. Available at: http://www.federalreserve.gov/apps/foia/ViewAllComments.aspx?doc_id=R-1432&doc_ver=1.
[57] Letter from Wells Fargo counsel James Strother (Feb. 13, 2012), available at: http://www.federalreserve.gov/SECRS/2012/March/20120309/R-1432/R-1432_021312_104984_362706050221_1.pdf.
[58] Video interview of Charles Munger, available at: http://www.webcompact.net/index.php/news/29149-charlie-munger-and-buffett-disagree-on-volcker-rule-video.
[59] ICBA Web site, available at: http://www.icba.org/aboutICBA/index.cfm?ItemNumber=529.
[60] ICBA comment letter on the Volcker Rule (Feb. 13, 2012), available at: http://www.federalreserve.gov/SECRS/2012/March/20120305/R-1432/R-1432_021312_104966_451638070183_1.pdf.
[61] *Id.*

time when the American economy is stuck in the doldrums and so many are unemployed or under-employed, the average compensation for the chief executives of four of the six largest banks in 2010 was $17.3 million—more than 262 times that of the average American worker. Thus, it is hardly surprising that the public would judge the banking industry harshly—and view Wall Street's executives and their intentions with skepticism ... The Wall Street banks continue to fight against regulation that would limit their capacity to trade for their own accounts—while enjoying the backing of deposit insurance—and thus seek to keep in place a system which puts taxpayers at high risk."[62]

The thousands of bankers unaffected by the Volcker Rule may not travel frequently to Washington to defend it. Who petitions City Hall about a stop light on a street where one doesn't drive? But as Washington's rulemakers finalize this important regulation, they should be especially attuned to the silence of 7,000 banks.

[62] M& T Bank, Annual Report, 2011, available at: http://files.shareholder.com/downloads/MTB/2107851053x0x546897/5C592DA0-5A87-4F46-8AF6-8639E1B8963E/2011_Annual_Report.pdf.