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Filed via email at: regs.comments@federalreserve.gov; VolckerReg.Comments@occ.treas.gov; comments@FDIC.gov; rule-comments@sec.gov; https://comments.cftc.gov

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Chair
Federal Reserve Board of Governors
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The Honorable Jelena McWilliams
Chair
Federal Deposit Insurance Commission
550 17th Street NW
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The Honorable Joseph M. Otting
Comptroller of the Currency
Office of the Comptroller of the Currency
U. S. Department of the Treasury
Independence Square
250 E Street NW
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The Honorable J. Christopher Giancarlo
Chair
Commodity Futures Trading Commission
Three Lafayette Centre
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The Honorable Jay Clayton
Chair
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

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

Docket ID OCC-2018-0010; Docket No. R-1608 and RIN 7100-AF 06; RIN 3064-AE67; File Number S7-14-18; RIN 3038-AE72

Dear Messrs. Powell, Otting, Clayton, and Giancarlo, and Ms. McWilliams:

In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") which included an amendment authored by Senators Jeff Merkley and Carl Levin codifying the "Volcker Rule" restricting high-risk proprietary trading.[1] In 2013, your agencies adopted final regulations implementing the Volcker Rule.[2] Today, five years later, your agencies are proposing to roll back key safeguards mandated by the 2010 statute and included in

[1] P.L. 111-203 (2010), § 619, adding § 13 to the Bank Holding Company Act, codified at 12 U.S.C. § 1851 et seq. (hereinafter the "Volcker Rule").
[2] 12 C.F.R. Parts 44, 248, and 351; 17 C.F.R. Parts 75 and 255 (hereinafter "2013 regulations"); final text released December 10, 2013; printed in the Federal Register, 79 FR 21 (1/31/2014).

the 2013 regulations.[3] The purpose of this letter is to oppose the 2018 Proposed Rule, because it often contravenes the statute it is supposed to be implementing, fails to provide the evidence, data, and justifications for proposed changes as required by the Administrative Procedures Act, and fails to effectively implement Volcker Rule safeguards against high-risk proprietary trading.

From 1999 to 2014, I served as a staff member of the U.S. Senate Permanent Subcommittee on Investigations under Senator Carl Levin. During my tenure as staff director and chief counsel, the Subcommittee conducted multiple bipartisan investigations into risky conduct by the largest financial institutions operating in the United States. The Subcommittee examined, among other matters, how financial institutions contributed to the financial crisis by issuing high-risk mortgage loans and derivatives in 2007 and 2008;[4] and how high-risk credit derivative trades by JPMorgan Chase in 2012, dubbed the "London whale" trades by the media, led to multi-billion-dollar losses.[5] Those investigations played key roles in the development of the Volcker Rule and its implementing regulations.

In addition to leading the Subcommittee staff efforts in the financial crisis and London whale investigations, I was one of several staffers who assisted Senator Levin in the drafting of the Merkley-Levin amendment codifying the Volcker Rule and in preparing his comment letters on the proposed rules leading to the 2013 implementing regulations.

Contrary to the statutory requirements of the Volcker Rule, the 2018 Proposed Rule would permit, and even encourage, more high-risk proprietary trading by federally insured banks and systemically important financial institutions. Among the Proposed Rule's many problems are provisions that would: (1) weaken the regulatory definition of "trading account"; (2) roll back important hedging safeguards; (3) increase U.S. vulnerability to foreign bank losses; (4) weaken protections against proprietary trading disguised as underwriting or market-making activities; (5) undermine the three percent limit on hedge fund and private equity fund investments; (6) loosen the liquidity management exclusion; (7) reduce Volcker Rule protections

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[3] "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," 83 FR 33432 (7/17/2018) (hereinafter "2018 Proposed Rule").

[4] See, e.g., "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 112-675 (4/13/2011), Parts I-IV (hereinafter "2011 PSI Financial Crisis Report"), http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:57319.pdf; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:57320.pdf; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:57321.pdf; and http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57322/pdf/CHRG-111shrg57322.pdf.

[5] "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses," U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 113-96 (3/15/2013), Volumes 1-2, (hereinafter "2013 PSI London Whale Hearing"), http://www.gpo.gov/fdsys/pkg/CHRG-113shrg80222/pdf/CHRG-113shrg80222.pdf and http://www.gpo.gov/fdsys/pkg/CHRG-113shrg85162/pdf/CHRG-113shrg85162.pdf.

at multi-billion-dollar banks across the country, and (8) eliminate Appendix B's requirement that banks establish an identifiable Volcker Rule compliance program.

Due to those and other flaws that would erode existing proprietary trading safeguards, the 2018 Proposed Rule should be withdrawn in its entirety. At a minimum, the provisions examined in this letter should be excised from any final rule. Advancing the proposal as currently drafted would invite both legal challenges and another financial crisis fueled by proprietary trading.

Limiting Proprietary Trading by U.S. Banks

Over the years, the United States has suffered multiple financial panics, downturns, and scandals that have damaged the U.S. financial system, U.S. economy, and American families. One recurrent problem has been high-risk proprietary trading by U.S. banks. As defined by the Volcker Rule, proprietary trading is trading undertaken by a bank engaging as a principal for its own account, rather than trading on behalf of its clients.[6] History has shown that when banks engage in proprietary trading, some undertake high-risk transactions, some engage in conflicts of interest disadvantaging their clients, and some incur massive losses requiring taxpayer bailouts.[7]

During the run-up to the stock market crash of 1929, the problem of proprietary trading became so severe that the 1933 Glass-Steagall Act explicitly prohibited national banks from trading for their "own account."[8] The Glass-Steagall provision provided a limited exception for certain "investment securities" which the Comptroller of the Currency, by regulation, could authorize a bank to trade.[9]

The Glass-Steagall restriction on proprietary trading remained on the books for more than 50 years, while U.S. banking recovered and eventually flourished. During that period, banks profited when their clients profited, and public confidence in U.S. banking institutions returned. In the 1980s, federal financial regulators began to erode some of the Glass-Steagall trading restrictions, allowing national banks to engage in financial transactions that hadn't been

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[6] Volcker Rule, § 13(h)(4). See also "The 'Volcker Rule': Proposals to Limit 'Speculative' Proprietary Trading by Banks," CRS, Report No. R41298 (6/22/2010), at 2 (defining proprietary trading as trading undertaken by a bank "investing as principal, rather than at the behest or for the benefit of customers, for the bank's own account").
[7] See, e.g., 2011 PSI Financial Crisis Report; 2013 PSI London Whale Hearing; "The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats," *Harvard Journal on Legislation* 48 (2), Senators Jeff Merkley and Carl Levin (2011)(hereinafter "2011 Merkley-Levin Harvard Essay"), at 515–553, http://harvardjol.wpengine.com/wp-content/uploads/2013/10/Merkley-Levin_Policy-Essay1.pdf.
[8] Glass Steagall Act, also known as the Banking Act, P.L. 73-66, § 16 (limiting national banks to "purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account"; national banks were also barred from underwriting or dealing in securities), codified at 12 U.S.C. § 24 (Seventh).
[9] Id.

permitted in decades.[10] In 1999, Congress enacted the Gramm-Leach-Bliley Act which, among other provisions, enabled certain banking entities once more to engage in trading to profit the entity's own account.[11]

Less than ten years later, the United States suffered a devastating financial crisis, fueled in part by high-risk proprietary trading by financial institutions active in the U.S. mortgage market.[12] As the value of many mortgage-related securities plummeted in 2007 and 2008, the resulting losses froze the mortgage market, destabilized multiple financial institutions, caused millions of Americans to lose their homes and their savings, led to enactment of the $700 billion Troubled Asset Recovery Program, and forced the Federal Reserve to provide a host of support programs for banks and securities firms, including by purchasing debt and easing access to the discount window. Federal agencies also extended guarantees for trillions of dollars in assets to prop up a range of financial firms and markets.[13]

Nevertheless, the losses suffered by the United States were catastrophic. Some estimates are that the financial crisis reduced U.S. gross domestic product by more than $20 trillion.[14]

In 2010, Congress enacted a wide range of banking reforms in the Dodd-Frank Act, including the Volcker Rule which revived the Glass-Steagall restriction on proprietary trading by banking entities. The Volcker Rule begins with this explicit prohibition:

> "Unless otherwise provided in this section, a banking entity shall not – (A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund."[15]

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[10] See, e.g., "Permissible Securities Activities of Commercial Banks Under the Glass-Steagall Act (GSA) and the Gramm-Leach-Bliley Act (GLBA)," U.S. Congressional Research Service, CRS Report No. R41181 (4/12/2010), at 8-15.
[11] Gramm-Leach-Bliley Act of 1999, also known as the Financial Services Modernization Act, P.L. 106-102. See also "Permissible Securities Activities of Commercial Banks Under the Glass-Steagall Act (GSA) and the Gramm-Leach-Bliley Act (GLBA)," U.S. Congressional Research Service, CRS Report No. R41181 (4/12/2010), at 15-16, 21.
[12] See, e.g., 2011 Merkley-Levin Harvard Essay; 2011 PSI Financial Crisis Report.
[13] See, e.g., "Treasury Announces Temporary Guarantee Program for Money Market Funds," Treasury Department press release (9/29/2008), http://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx; "Temporary Liquidity Guarantee Program: Fourth Quarter 2010," FDIC, https://www.fdic.gov/regulations/resources/tlgp/archive.html.
[14] See, e.g., "How Bad Was It? The Costs and Consequences of the 2007–09 Financial Crisis," Federal Reserve Bank of Dallas staff paper, Tyler Atkinson, David Luttrell and Harvey Rosenblum (7/2013), https://dallasfed.org/assets/documents/research/staff/staff1301.pdf; "Financial Regulatory Reform: Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act," U.S. Government Accountability Office, Report No. GAO-13-180 (1/2013), http://www.gao.gov/assets/660/651322.pdf.
[15] Volcker Act, § 13(a)(1).

Subsequent provisions of the Volcker Rule – like the Glass-Steagall provision after which it was modeled – permit banking entities to engage in a carefully circumscribed set of lower-risk, client-serving activities and limited investments in hedge funds and private equity funds. The Volcker Rule authors have explained that the new provision was intended to function as a modernized version of the Glass-Steagall provision, aimed at eliminating higher-risk activities geared to producing profits for the bank itself, while permitting lower-risk activities advancing the interests of bank clients.[16]

In the eight years since the Volcker Rule has been on the books, the U.S. banking industry has not only recovered from the financial crisis, but also reached new heights of profitability and lending.[17] Despite that happy record, the banking industry has engaged in a relentless campaign to relax the Volcker Rule restrictions on proprietary trading. In May 2018, the banks scored their first victory when Congress enacted legislation exempting certain banks holding less than $10 billion in total assets and limited trading portfolios from the Volcker Rule's proprietary trading restrictions.[18] Now, America's largest banks are urging promulgation of the 2018 Proposed Rule, an ill-conceived rollback of proprietary trading safeguards protecting U.S. taxpayers, the U.S. financial system, and the U.S. economy.

Making Changes to the Existing Volcker Rule Regulations

The 2018 Proposed Rule seeks to make major changes to the Volcker Rule's implementing regulations. The Administrative Procedure Act ("APA") of 1946, which governs the federal rulemaking process and defines the scope of judicial review of new regulations, "requires [courts] to hold unlawful agency action that is 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law' or that is 'unsupported by substantial evidence.'"[19] The Supreme Court has ruled that, to meet the APA's standards, an agency "must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[20]

As detailed more fully below, the 2018 Proposed Rule fails to meet the standards set by the APA, as interpreted by the U.S. courts. The Proposed Rule does not offer "substantial evidence," "relevant data," or "satisfactory explanations" to support its recommended changes, nor does it demonstrate that its changes are "in accordance with law." It does not describe any

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[16] See, e.g., 2011 Merkley-Levin Harvard Essay, at 538-39.
[17] See, e.g, "Quarterly Banking Profile: First Quarter 2018," Federal Deposit Insurance Corporation (3/2018), https://www.fdic.gov/bank/analytical/qbp/2018mar/qbp.pdf; "Top investment bank profits at pre-crisis levels," *Financial Times*, Laura Noonan, (6/10/2018), https://www.ft.com/content/47661792-68a6-11e8-8cf3-0c230fa67aec.
[18] Economic Growth, Regulatory Relief, and Consumer Protection Act, S. 2155, § 203, P.L. 115-174 (5/24/2018)(authorizing the exemption only for banks with less than $10 billion in total assets and whose trading assets and liabilities do not exceed five percent of their total assets).
[19] *Susquehanna International Group v. SEC,* 866 F.3d 442, 446 (D.C. Cir. 2017) (citing 5 U.S.C. § 706(2)(A), (E); *NetCoalition v. SEC,* 615 F.3d 525, 532 (D.C. Cir. 2010)).
[20] *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines, Inc. v. United States,* 371 U.S. 156, 168 (1962)).

deliberative process through which key facts, broad-based data, or regulatory alternatives were compiled and considered. It does not present data trends, or articulate how current practices have affected banks' risk profiles, client base, or profitability. It does not identify or analyze countervailing facts nor explain why possible regulatory alternatives were not chosen.

Instead, to support the changes it advances, the 2018 Proposed Rule offers generalized complaints by unnamed sources or generalized promises to improve current practice, without supplying the detailed evidence and relevant data required by the APA. It does so even though regulators have access to four years of Volcker Rule implementation data which financial institutions were required to submit under Appendix A of the existing regulations.[21]

For example, as discussed below, the 2018 Proposed Rule seeks to eliminate the current obligation of banking entities to perform correlation analyses demonstrating that, over time, their hedges are actually reducing their financial risks and not functioning as covert proprietary trades. The Proposed Rule fails to provide any specific evidence, data, or explanation showing why the existing requirement is problematic. The Proposed Rule fails to provide, for example, any factual evidence that correlation analyses are difficult to perform or unreliable, that a meaningful percentage of banks incur substantial costs to execute those analytical procedures, or that performing the analyses somehow interfered with the banks' ability to implement effective hedges. In fact, the Proposed Rule fails to provide any data whatsoever about hedging activities under the Volcker Rule, including related to correlation analyses. The utter absence of factual data is particularly striking in light of the fact, discussed further below, that at least one major bank, JPMorgan Chase, was routinely using correlation analyses to evaluate most of its hedges in 2013, when the existing Volcker Rule regulations were finalized.

Rather than offer evidentiary support for its changes, the Proposed Rule simply asserts that the agencies have "learned" since the initial implementation of the Volcker Rule and are ready to "improve" it. Those generalized statements are insufficient under the APA to justify changing existing regulatory practices, particularly when the banking industry is enjoying record profits, increased lending, and the lower risk profiles that the Volcker Rule was intended to produce. The Proposed Rule simply fails to meet its burden of justifying the changes it wants.

In addition to its failure to comply with the APA, the 2018 Proposed Rule should be rejected for multiple substantive reasons. The comments below focus on:

- the proposed re-definition of "trading account";
- the proposed weakening of existing hedging safeguards;
- the proposed weakening of protections against foreign bank losses;
- the proposed weakening of underwriting and market-making safeguards;
- the proposed weakening of statutory limits on fund investments;
- the proposed expansion of the liquidity management exclusion;
- the proposed reduction of regulatory protections at multi-billion-dollar banks; and
- the proposed elimination of Appendix B.

[21] See 2018 Proposed Rule at 33435 ("Agencies have collected nearly four years of quantitative data required under Appendix A of the 2013 final rule.").

Altering the Trading Account Definition

The 2018 Proposed Rule should be rejected for multiple reasons. One of the more important is its attempt to alter the current definition of "trading account" in the 2013 regulations implementing the Volcker Rule. The term "trading account" is key to the entire Volcker Rule, since it identifies the universe of transactions subject to proprietary trading restrictions.[22] The proposed changes do not comport with the statute nor meet the requirements of the APA.

The Volcker Rule states in § 13(h)(4) that "proprietary trading" means "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" specified by regulation.[23] In § 13(h)(6), the Volcker Rule states that "trading account" means "any account used for acquiring or taking positions in the securities and instruments described in paragraph (4) principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)" and any other account specified by regulation.[24]

To implement the statute, the 2013 regulations define "trading account" using a three-part approach. The three parts include what are known as the "short-term" prong, "market risk capital" prong, and "dealer" prong. The short-term prong, which is the one targeted by the 2018 Proposed Rule, covers any account used by a banking entity to buy or sell a financial instrument principally for the purpose of (i) short-term resale; (ii) benefitting from short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging any of those activities.[25] It is this part of the 2013 definition that directly reflects the statute's explicit focus on "near term" transactions and "short-term" price movements. In addition, the 2013 regulations establish a rebuttable presumption that any trading position held for fewer than 60 days is undertaken on behalf of the banking entity's own trading account, thereby providing a bright line rule for identifying transactions that qualify as "near term."[26]

The 2018 Proposed Rule suggests eliminating both the short-term prong and the 60-day rebuttable presumption,[27] which would essentially delete the provisions that most directly implement the statutory requirements related to near term transactions and short-term price movements. Eliminating those provisions would unmoor the regulations from the law.

The 2018 Proposed Rule seeks to make those changes even though it explicitly recognizes the centrality of the statute's focus on near term transactions and short-term price movements. Here is how the Proposed Rule first describes the Volcker Rule:

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[22] See, e.g., 2013 regulations, Supplementary Information, 79 FR 21 (1/31/2014), at 5820, n. 129.
[23] Volcker Rule, § 13(h)(4).
[24] Id., § 13(h)(6).
[25] See 2013 regulations, §__.3(b)(1)(i).
[26] See 2013 regulations, §__.3(b)(2).
[27] Proposed Rule at 33447.

> "Section 13 of the BHC Act generally prohibits banking entities from engaging as principal in trading for the purpose of selling financial instruments in the near term or otherwise with the intent to resell in order to profit from short-term price movements."[28]

Contrary to its own description of the essence of the Volcker Rule, the Proposed Rule seeks to remove explicit references to near term transactions and short-term price movements from the regulatory trading account definition. The Proposed Rule fails to offer any explanation of how that change comports with the regulators' obligation to implement the statute as written.

In discussing removal of the short-term prong, the Proposed Rule states that "[i]n the experience of the Agencies, determining whether or not positions fall into the short-term intent prong … has often proved unclear and subjective, and, consequently, may result in ambiguity or added costs and delays."[29] That reasoning cannot justify, however, ignoring the plain language of the law. Moreover, the Proposed Rule fails to support its assertion with any specific evidence or broad-based data, or even any anecdotal examples, demonstrating implementation difficulties or inappropriate costs, despite having access to four years of implementation data. Generalized assertions that an existing rule has "often" proved "unclear" and "may" result in added costs, without supporting evidence or data, is insufficient to meet the APA's standards justifying a regulatory change. The Proposed Rule also fails to explain why the 60-day presumption – an entirely objective test – is insufficient to resolve any alleged ambiguities over whether a specific transaction falls within the short-term prong. Still another problem is the Proposed Rule's failure to provide any specific data showing how the short-term prong or 60-day presumption has unduly constrained banking entities. Given growing profits and lending in the U.S. banking sector, it may be that such data does not exist.

Nevertheless, in place of the short-term prong, the Proposed Rule recommends using a newly developed "accounting prong." That new prong would define "trading account" as applying to transactions involving financial instruments "recorded at fair value on a recurring basis under applicable accounting standards."[30] The Proposed Rule offers three examples of financial instruments that would be encompassed by this new prong, but does not specify any that would be excluded.[31] If it is intended to expand the existing definition to reach more types of financial instruments, the Proposed Rule fails to identify any new instruments that would be added. If it is intended to reduce the scope of the existing regulation, the Proposed Rule fails to explain what financial instruments would be excluded from coverage for the first time. It is hard to understand how a rulemaking meets its APA obligations without articulating the changes expected to result from a revised rule. The Proposed Rule also fails to provide a convincing rationale explaining why the accounting prong would be more effective or appropriate than the short-term prong in carrying out the stated objectives of the statute.

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[28] Id. at 33434.
[29] Id. at 33438. See also id. at 33447.
[30] Id. at 33438.
[31] Id. at 33438, 33447-48.

The Proposed Rule would also create a "presumption of compliance" with the Volcker Rule for any trading desk: (1) that is not subject to the market risk capital prong or the dealer prong; and (2) whose purchase and sales of covered financial instruments stay below a $25 million ceiling. Each trading desk would have to determine for itself whether it qualifies for the presumption by calculating "the net gain or loss on the trading desk's portfolio of financial instruments each business day, reflecting realized and unrealized gains and losses since the previous business day, based on the banking entity's fair value for such financial instruments," and then calculating "the sum of the absolute values of the daily net gain and loss figures for the preceding 90-calendar-day period" to determine whether, on a 90-day rolling basis, its trading activities fall below the $25 million ceiling.[32]

The proposed "presumption of compliance" is inconsistent with the law. On its face, the statute prohibits proprietary trading. Nowhere does it authorize a de minimis amount of proprietary trading such as $25 million per trading desk. In addition, the Proposed Rule offers no specific evidence or data justifying the $25 million ceiling. Instead, the Proposed Rule simply declares, without any detail or explanation, that unspecified "metrics" obtained by the agencies "typically" indicated that trading desks falling below the $25 million ceiling were not engaged in prohibited proprietary trading. The information provided is so minimal – with no description of the "metrics" used, the number of banks or trading desks examined, or how the determination was made that no proprietary trading occurred at those desks (plus the puzzling reference to "typically") – that no analysis of the $25 million figure or possible alternatives is possible. The Proposed Rule also fails to specify or analyze the types of assets, trading operations, or markets that would be affected by the change. Without that basic information, it is virtually impossible to assess the proposed change's likely impacts or costs.

In addition, far from simplifying the 2013 approach, the new presumption would introduce a host of complex terms and procedures that would complicate and could undermine application of the Volcker Rule.

First, the proposal would require every trading desk, using the specified calculations, to make an individual determination "each business day"[33] on an ongoing basis as to its eligibility to invoke the presumption, a burdensome daily determination with significant procedural consequences.[34] Second, the proposal relies on each trading desk calculating with precision the "fair value" and profit-loss margins of a wide gamut of financial instruments. It is critical to recognize, however, that current accounting rules give financial institutions substantial discretion in valuing many financial instruments, including, for example, derivatives whose fair value can be determined using virtually any price offered during the day in the marketplace, whether or not that price is at the midpoint of the day's price range or an outlier.[35] That degree of accounting discretion can produce large variations in derivative values and could give rise to differing opinions as to whether a particular trading desk would fall below the $25 million ceiling.[36]

[32] Id.
[33] See, e.g., proposed OCC § 44.3(c)(1)(i).
[34] See, e.g., proposed OCC § 44.3(c)(3).
[35] See, e.g., 2013 PSI London Whale Hearing, Volume 1, at 270-73.
[36] See, e.g., id. at 278, 315, 318, 325.

Third, the proposal requires banking entities to calculate "the sum of the absolute values of the daily net gain and loss figures for the preceding 90-calendar-day period," a calculation that is more detailed, extended in time, and laced with uncertainty than the existing bright line rule that asks only whether a trade was made within a 60-day period.

Another problem is that the Proposed Rule does not restrict and apparently would allow banks to establish an unlimited number of trading desks. That means a bank could establish a network of trading desks, each designed to fall below the $25 million threshold, and thereby manufacture a bank-wide presumption of compliance. That approach would undermine the Volcker Rule by allowing a bank to presume proprietary trading restrictions were being met without any actual testing, documentation, or verification. This obvious problem with the proposal is neither acknowledged nor addressed in the 2018 Proposed Rule nor is it clear how or to what extent regulators could, in fact, constrain a bank's formation of trading desks.

A related problem involves regulatory oversight. It is far from clear how regulators would have the resources or time to review the accounting procedures, valuations, and daily calculations of multiple trading desks within a complex multinational financial institution.

Finally, the London whale trades episode suggests the folly of the proposed approach by offering a real world example of how a large bank may allow a trading desk to record improper asset values in its trading book and avoid detection of even large losses by regulators until it's too late. In that scandal, JPMorgan Chase traders deliberately inflated the fair value of the credit derivatives they were trading in order to hide trading losses.[37] A mandatory internal bank process intended to detect and prevent such valuation misstatements instead allowed them to stand, even after a special review. More importantly, the scandal exposed the fact that current accounting rules give banks significant leeway in valuing their derivatives, which JPMorgan Chase used to justify its initial acceptance of the inflated values. During the three months that the losses deepened, regulators failed to detect that the JPMorgan traders had changed their pricing methodology and misrepresented the bank's profits and losses. The regulators learned of the misconduct only after news reports publicly disclosed the bank's massive losses.

The London whale trades scandal demonstrates how easily a trading desk – even one located in a bank with a team of on-site bank examiners – can manipulate asset values to avoid oversight. It illustrates the recklessness of creating a presumption of compliance that would essentially enable a bank's trading desks to police themselves, yet the 2018 Proposed Rule fails even to acknowledge, much less grapple with that scandal's painful lessons.

Together, the proposed elimination of the short-term prong from the trading account definition, substitution of a so-called accounting prong, and addition of a presumption of compliance fail to comport with the law and are unsupported by the type of evidence, data, and explanations required by the APA. Those arbitrary and capricious proposals should be rejected.

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[37] Id. at 161-64, 175, 273-336.

Rolling Back Key Hedging Safeguards

A second set of ill-considered changes in the Proposed Rule involve hedging. The proposed changes do not comply with the statute, fail to meet the requirements of the APA, and would roll back important hedging safeguards for no apparent benefit.

The Volcker Rule states that, notwithstanding its ban on proprietary trading, a banking entity may engage in "[r]isk-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."[38]

The 2013 regulations faithfully implement that part of the statute by requiring banking entities, when claiming to engage in this permitted activity, to document the assets or positions being hedged, identify the transactions being used to hedge those assets or positions, and confirm that the hedge is designed to reduce the attendant risks. The 2013 regulations also require the banking entity to perform correlation analyses to show that, over time, the hedge is, in fact, reducing the targeted risks.[39]

The 2013 regulations took this careful approach to hedging in part because of abuses uncovered in connection with the London whale trades scandal. In that scandal, JPMorgan Chase claimed to have created and actively traded a complex portfolio of high-risk credit derivatives in order to hedge overall "credit risks" facing the bank.[40] When asked to substantiate that assertion, however, the bank was unable to identify the assets or positions being hedged, or demonstrate how the credit derivatives portfolio reduced the bank's credit risks. To the contrary, bank analyses showed that the value of the credit derivatives portfolio was rising and falling in tandem with the bank's other holdings, without performing any hedging function.

The scandal revealed further that JPMorgan Chase normally employed detailed internal procedures to document, monitor, and test its hedges – identifying the assets being hedged and performing ongoing correlation tests to measure the hedge's effectiveness in reducing risk. But none of those documentation or testing controls had been applied to the credit derivatives portfolio. After reviewing that and other evidence gathered in connection with an inquiry into the London whale trades by the U.S. Senate Permanent Subcommittee on Investigations, Subcommittee Chair Carl Levin and Ranking Republican John McCain concluded on a bipartisan basis that the bank had "mischaracterized" its trading activity as a hedge.[41]

The Levin-McCain report noted that federal regulators who'd examined JPMorgan's claim that its high-risk credit derivatives portfolio functioned as a hedge were also unimpressed. One bank examiner had dismissively described the credit derivatives portfolio as a "make

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[38] Volcker Rule, § 13(d)(1)(C).
[39] See 2013 regulations, in §__.5.
[40] See 2013 PSI London Whale Hearing, Volume 1, at 206-214.
[41] Id. at 174.

believe voodoo magic 'Composite Hedge.'"[42] In 2013, as regulators worked to finalize the Volcker Rule implementing regulations, Federal Reserve Governor Daniel Tarullo stated: "In light of the London Whale, which came to light between the proposed rule and now, one of the key mandates to the staff from all the five agencies working on the final rule has been to ensure that London Whale in substantive and procedural terms couldn't happen again."[43]

Despite this instructive history behind the hedging provisions in the 2013 regulations, the 2018 Proposed Rule would weaken the safeguards put in place to ensure that banks do not mischaracterize their proprietary trades as hedges. Specifically, the Proposed Rule would:

> "eliminate the current requirement that the hedging activity 'demonstrably reduces' or otherwise 'significantly mitigates' risk, reduce documentation requirements associated with risk-mitigating hedging transactions that are conducted by one desk to hedge positions at another desk with pre-approved types of instruments within pre-set hedging limits, and eliminate the 2013 final rule's correlation analysis requirement."[44]

Eliminating the existing regulatory requirement that banks show an alleged hedge "demonstrably reduces" or "significantly mitigates" the risks targeted by the hedge would be a direct repudiation of the statute, since that type of demonstration is at the heart of the statutory provision and explicitly required by the law. The proposed reduction in documentation would weaken the statute's requirement that banks establish their hedging activities are "designed to reduce the specific risks" associated with the specific assets being hedged. Eliminating the correlation analysis requirement would eliminate the primary means used by most banks today to ensure a hedging activity is, in fact, offsetting risk.

At the same time, as explained earlier, the Proposed Rule fails to offer substantial evidence or broad-based data to justify the changes being advanced. The Proposed Rule contends that agency "experience" with the current hedging safeguards indicates that the existing system is not working well, but offers no details, examples of problems, or industry-wide data. In fact, the Proposed Rule offers no hedging data or analysis of any kind, despite the availability of extensive implementation data that could be used for that purpose. It also fails to identify any benefits that would accrue from eliminating the rule's common-sense hedging safeguards.

Together, the proposed changes would likely lead banks to handle hedges undertaken pursuant to the Volcker Rule differently – with less planning, documentation, and testing – than other hedges within the bank. That potential result is so contrary to good management and risk-

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[42] Id. at 161, 644.
[43] "Tarullo: Volcker rule designed to prevent 'Whale'," Marketwatch, Steve Goldstein (11/22/2013), https://www.marketwatch.com/story/tarullo-volcker-rule-designed-to-prevent-whale-2013-11-22.
[44] Proposed Rule at 33438-39. See also id. at 33464-67.

reduction practices that the proposed provisions warrant rejection, not only for being contrary to law, but also as the type of arbitrary and capricious regulatory action prohibited by the APA.[45]

Increasing U.S. Vulnerability to Foreign Bank Losses

A third set of troubling provisions in the 2018 Proposed Rule would increase American taxpayer vulnerability to proprietary trading losses incurred by foreign financial institutions. The proposed changes do not comply with the statute, fail to meet the requirements of the APA, and would diminish important U.S. protections against foreign bank losses. They would also disadvantage U.S. banks compared to their foreign competitors.

The Volcker Rule states that its restrictions on proprietary trading do not apply to foreign banks engaging in proprietary trades "provided that the trading occurs solely outside of the United States" and the foreign bank "is not directly or indirectly controlled by a banking entity that is organized under" U.S. federal or state law.[46] The aim of those statutory provisions is to ensure that any proprietary trading losses incurred by foreign banking entities are sufficiently disconnected to the United States that they do not trigger a U.S. taxpayer bailout.

The 2013 regulations faithfully implement that part of the statute by creating a set of bright line rules specifying when proprietary trades by foreign banking entities occur "solely outside of the United States." Those bright line rules provide that the foreign banking entity cannot be located in the United States or organized under U.S. federal or state law, foreign banking personnel arranging the transactions cannot be physically located within U.S. borders, the counterparty cannot be a U.S. entity (with some exceptions), and the foreign bank's U.S. operations cannot provide the financing.[47] Together, these provisions ensure that, to avoid the Volcker Rule's safeguards, the proprietary trading conducted by a foreign banking entity takes place "solely outside of the United States."

Inexplicably, the 2018 Proposed Rule seeks to diminish the 2013 regulations' bright line rules by allowing some foreign banking personnel to be located within the United States, allowing some U.S. counterparties to participate in the trades, and eliminating altogether the prohibition on the foreign bank's obtaining from its U.S. operations the financing needed to conduct its proprietary trades.[48] When trades are arranged in part by personnel located within the United States, are entered into with U.S. counterparties, or are financed by U.S.-based entities, those trades are no longer taking place outside of U.S. borders. On their face, the proposed changes contravene the statute's plain language which exempts from the Volcker Rule only those foreign bank proprietary trades that occur "solely outside of the United States."

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[45] In addition to the changes just discussed, the 2018 Proposed Rule recommends significantly reducing Volcker Rule hedging safeguards at banks with less than $50 billion in trading assets and liabilities. See comments, *infra*, opposing that regulatory approach.
[46] Volcker Rule, § 13(d)(1)(H).
[47] 2013 regulations, § __.6(e); Proposed Rule at 33467-68.
[48] 2018 Proposed Rule at 33439, 33468.

In addition to contravening the statute, the proposed changes would, as a practical matter both individually and collectively, increase the vulnerability of the United States to foreign bank proprietary trading losses. Less than ten years ago, the United States learned to its detriment how foreign bank losses could end up hurting U.S. taxpayers and the U.S. financial system. During the financial crisis, the Federal Reserve lent billions of dollars to many foreign banks due to losses they suffered and the impact their failures would have had on the United States.[49]

Similar problems could arise if foreign banks were to engage in high-risk proprietary trades, incur losses, and be unable to repay the financing provided by their U.S. operations. If U.S. financing were at stake, losses ostensibly occurring outside of the United States could be transferred to entities within U.S. borders.[50] In a worst-case scenario, the foreign bank's U.S. operations could spread the contagion to its U.S. customers, including U.S. financial institutions and other businesses. Eliminating the ban on U.S. financing of foreign bank proprietary trades would, in particular, open the door to foreign banks exporting losses to the United States.

Another set of concerns involves unfair competition between U.S. and foreign banks. In effect, the proposed changes would allow large foreign banks operating in the United States to engage in proprietary trading activities that large U.S. banks are prohibited from undertaking. Allowing foreign bank personnel physically located in the United States to help conduct those proprietary trades – with U.S. counterparties in some cases – would twist the knife especially deep. The Proposed Rule would, in effect, enable foreign banks to engage in more high-risk trading than their U.S. competitors, while also offering the foreign banks the option of offloading any losses onto the U.S. financial system. It is difficult to understand why the Proposed Rule would seek to create that type of advantage for foreign banks over their U.S. competitors.

A similar set of concerns applies to a related attempt by the Proposed Rule to weaken existing bright line rules restricting foreign banking entities seeking to invest in hedge funds and private equity funds to doing so "solely outside of the United States."[51] The 2013 regulations exempt such transactions from the Volcker Rule "only if" the foreign banking entity is not located in the United States or organized under U.S. federal or state law, foreign banking personnel arranging the transactions are not physically located within U.S. borders, the

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[49] See, e.g., "Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance," U.S. Government Accountability Office, Report No. GAO-11-696, at 130-135 (2011)(indicating that, according to Federal Reserve records, Barclays, Credit Suisse, Deutsche Bank, Royal Bank of Scotland, and UBS, among other foreign banks, received significant financial support during the financial crisis). Foreign banks reportedly accounted for about 70 percent of the Federal Reserve's discount window loans during the peak of the financial crisis. See, e.g., "Foreign Banks Used Fed Secret Lifeline Most at Crisis Peak," Bloomberg, Bradley Keoun and Craig Torres (4/1/2011),http://www.bloomberg.com/news/2011-04-01/foreign-banks-tapped-fed-s-lifeline-most-as-bernanke-kept-borrowers-secret.html.

[50] In the case of the London whale trades, for example, the original trading losses were incurred by JPMorgan traders in London, but were financed in part with U.S. deposits and were ultimately included in JPMorgan Chase's U.S. financial statements. See, e.g., 2013 PSI London Whale Hearing, Volume 1, at 198-206, 264, 276-77.

[51] 2018 Proposed Rule at 33484-85.

investments do not appear on the books of a U.S. entity, and the foreign bank's U.S. operations do not provide the financing.[52] In addition, the 2013 regulations bar foreign banking entities from offering for sale or selling interests in the foreign funds to U.S. residents.[53]

The 2018 Proposed Rule would make two changes to those existing regulations: it would eliminate the ban on foreign banks obtaining financing from their U.S. operations for their trading efforts; and it would re-word the marketing restriction to apply only to funds for which the foreign banking entity is a sponsor or adviser, and not to third-party funds where the foreign banking entity plays neither role.[54] Both changes seek to make it easier for foreign banking entities to invest in foreign hedge funds or private equity funds and to sell fund interests to Americans. As such, both proposals would, once again, tilt the playing field in favor of foreign banks by allowing them to sell financial products to U.S. clients that U.S. banks may not. In addition, both changes would increase U.S. vulnerability to any losses suffered by those foreign banks. The Proposed Rule offers no justification for disadvantaging U.S. banks compared to their foreign competitors or for increasing U.S. vulnerability to foreign bank losses.

Finally, as with other provisions, the Proposed Rule provides no specific evidence or broad-based data to support the changes being recommended. Nor does it provide basic factual information needed to evaluate the proposed changes. For example, the rulemaking does not identify the number of foreign banks that currently engage in proprietary trading outside of the United States, the dollar volume of their foreign proprietary trades, the types of risks or magnitude of losses potentially at stake, or the number of U.S. banks that might be disadvantaged. The Proposed Rule simply fails to provide the factual foundation and supporting evidence that the APA requires to justify the changes being advanced.

Over the past four years, the 2013 regulations have protected U.S. taxpayers and the U.S. financial system from foreign banks engaged in high-risk proprietary trades. Apparently, no large foreign bank has offloaded its foreign proprietary trading losses onto its U.S. operations during that period, and no U.S. assistance to a foreign bank has been necessary due to proprietary trading missteps. In light of that positive record and the statute's explicit language excluding from its coverage only foreign bank trading that occurs "solely outside of the United States," the proposed changes to the existing foreign bank safeguards should be rejected.

Weakening Protections Against Proprietary Trading Disguised as Underwriting or Market-Making Activity

A fourth set of troubling changes in the Proposed Rule involves the Volcker Rule provisions related to underwriting and market-making-related activities. The proposed changes do not comply with the statute, fail to meet the requirements of the APA, and would roll back important safeguards against high-risk proprietary trading.

[52] 2013 regulations, § __.13(b)(4).
[53] Id., § __.13(b)(3).
[54] 2018 Proposed Rule at 33485-86.

The Volcker Rule states that, notwithstanding its ban on proprietary trading, a banking entity may engage in "underwriting or market-making-related activities, to the extent that any such activities … are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."[55] Underwriting and market-making-related activities typically involve banks purchasing financial instruments that their clients might want to buy or sell. The purpose of the Volcker Rule's limitation is to ensure that banks purchase only the amount of financial instruments that their clients might need in the "near term," and prevent a bank from purchasing those same instruments as a covert way of trading for its own account.

The 2013 regulations faithfully implement that part of the law.[56] The regulations appear to be working well, given the profitability and increased lending experienced by the U.S. banking sector. Nevertheless, the 2018 Proposed Rule seeks to modify the existing regulations by establishing a new rebuttable presumption that a banking entity which buys financial instruments "within internally set risk limits" satisfies the statutory requirement that its underwriting and market-making-related activities are "designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties."[57]

The Proposed Rule does not provide a detailed explanation for creating the new presumption. The only explicit reason given is that some "public commenters have observed that the significant compliance requirements in the regulation **may** unnecessarily constrain underwriting without a corresponding reduction in the type of trading activities that the rule was designed to prohibit."[58] The Proposed Rule fails to provide any specific evidence or broad-based data demonstrating that, in fact, the existing regulations have constrained bank underwriting or market-making-related activities, despite the regulators' having access to four years of implementation data. Nor does the rulemaking provide basic factual information needed to evaluate current practices and the impacts of the proposed presumption, including the levels of underwriting and market-making activities, their costs, and related profits over the past four years. By omitting supporting evidence and basic factual data from its analysis, the Proposed Rule fails to meet the APA's requirements to justify the changes being advanced.

In addition to lacking a detailed justification, the proposed presumption suffers from multiple flaws. One of the most important is it proposes to use internal bank risk limits as a means for determining the near term trading needs of bank clients. Banks normally use risk limits to establish a dollar limit on acceptable losses for a portfolio or banking unit, and enable risk managers to detect and restrain bank traders who are nearing that dollar limit and unacceptably increasing the bank's risk of loss. For example, Value-at-Risk (VaR) models use

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[55] Volcker Rule, § 13(d)(1)(B).

[56] See 2013 regulations, § __.4.

[57] See 2018 Proposed Rule at 33438, 33454. In addition, the Proposed Rule seeks to eliminate the compliance program requirements altogether for exempted underwriting and market-making-related activities at banks with less than $50 billion in trading assets and liabilities. Proposed Rule at 334558. See comments, *infra*, opposing that regulatory approach.

[58] 2018 Proposed Rule at 33455 (emphasis added). See also id. at 33459 (the 2013 market-making-related regulations "**may** be overly broad and complex, and also **may** inhibit otherwise permissible market making-related activity")(emphasis added).

historical profit and loss data to calculate a dollar figure representing the most money that a portfolio of assets could be expected to lose over a fixed period of time to a certain degree of confidence.[59] Banks generally instruct their traders not to conduct trades that exceed the relevant VaR limit, because that trading activity would place the bank in danger of incurring higher losses than its risk managers consider safe.

Banks use risk limits to gauge and control their trading risks; risk limits are not intended to and normally have nothing to do with gauging client demand. Using one to measure the other is conceptually inappropriate and contrary to the intended function of risk limits. In addition, since virtually all bank transactions are supposed to fall beneath a bank's risk limits, if the proposed provision were to be adopted, virtually all of a bank's transactions would routinely be able to take advantage of the new presumption – a result which could lead to the presumption's essentially nullifying active implementation of the statutory prohibition against banks buying financial instruments in excess of near term client demand.

Still another problem is that the banks themselves normally control the setting of their risk limits, despite evidence that some banks manipulate those limits to allow otherwise prohibited transactions. JPMorgan's manipulation of its own risk limits, for example, played a key role in the London whale trades scandal. In that matter, JPMorgan Chase set a VaR limit on its credit derivatives portfolio, but when the portfolio exceeded its limit due to massive purchases of highly risky credit derivatives, instead of de-risking the portfolio, the bank simply raised the VaR limit.[60] The credit derivatives trading then continued, eventually triggering multi-billion-dollar losses that would never have occurred if the original risk limit had been respected.

Regulators failed to stop the high-risk trading at JPMorgan Chase due to a lack of information about the credit derivatives portfolio, a mismarked trading book that hid mounting losses, a failure to investigate repeated risk limit breaches, and the difficulty of conducting a timely evaluation of the bank's revised risk limit.[61] The 2018 Proposed Rule takes no notice of those regulatory difficulties, however. To the contrary, instead of continuing the current practice of requiring banks to use historical data and other measures to ensure their trading desks do not make purchases in excess of near term client demand, the Proposed Rule shifts the burden to regulators – making regulators responsible for determining when a bank's purchases are excessive and make inappropriate use of the presumption.[62] Requiring regulators rather than

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[59] See, e.g., OCC definition of VaR, 12 C.F.R. Part 3, Appendix B, Section 2 ("*Value-at-Risk (VaR)* means the estimate of the maximum amount that the value of one or more positions could decline due to market price or rate movements during a fixed holding period within a stated confidence interval.").
[60] See 2013 PSI London Whale Hearing, Volume 1, at 175, 351-76.
[61] See id. at 411-19, 425-33, 439-41.
[62] See, e.g., proposed OCC § 44.4(a)(8)(iv); 2018 Proposed Rule at 33556 ("Rebutting the presumption. The presumption in paragraph (a)(8)(i) of this section may be rebutted by the OCC if the OCC determines, based on all relevant facts and circumstances, that a trading desk is engaging in activity that is not based on the reasonably expected near term demands of clients, customers, or counterparties.").

bank personnel to spot in the first instance when bank purchases exceed near term client demand is both impractical and wrong-headed.

Given the real world example of the London whale trades and the practical limits on regulatory oversight, the Proposed Rule's suggested approach – creating a rebuttable presumption that trades falling below a bank's internal risk limits do not exceed clients' near term demand – is a recipe for disaster. The predictable result is that every trading desk will invoke the presumption while buying all the financial instruments allowed by its risk limit, without actually evaluating client demand. Every trading desk will have ample opportunity to use those transactions to engage in covert proprietary trading. To detect and stop those proprietary trades, regulators will be forced to monitor and second-guess the trading volumes of multiple individual trading desks within a complex financial institution, a near impossible task.

Further, the Proposed Rule would replace the current regulatory approach, which provides a consistent methodology for measuring near term client demand across financial institutions, with one that would vary according to the internal risk tolerances of each institution. Worse, the new approach would reward more aggressive firms using higher risk limits with the opportunity to engage in more trading, while limiting trades at the more cautious firms with more prudent risk limits. One predictable outcome is that the proposed regulatory approach would encourage banks to inflate their risk limits in order to engage in more unfettered trading. Yet the Proposed Rule does not acknowledge or address that problem. It also fails to offer any factual evidence to support its approach, such as a finding that major U.S. banks currently use relatively similar risk limits and would be unlikely to change them even if those risk limits were used to gauge their clients' near term demand. It simply omits any discussion of the problems associated with using varying risk limits to gauge near term client demand and allowable trading volumes.

Finally, the Proposed Rule ignores the new supervisory challenges that would be created by the proposed change. In particular, under the new approach, what one banking entity might treat as permitted market-making activities could easily be prohibited at another similarly situated entity due to differing internal risk limits. The facts could require disparate enforcement actions for the exact same conduct by two different banks — again, based on the banks' own risk appetites. Complaints to regulators would inevitably follow.

The Proposed Rule's use of risk limits as a proxy for client demand has no rational basis. The proposed presumption fails to implement the statute's plain language and creates an unworkable regulatory scheme. The proposed changes to the underwriting and market-making-related regulations should be rejected as arbitrary and capricious, and in violation of the APA.

Undermining the 3% Limit on Covered Fund Investments

A fifth set of troubling provisions in the 2018 Proposed Rule would increase the ability of large U.S. banks to invest in high-risk hedge funds and private equity funds. The Proposed Rule does so by expanding the ability of large U.S. banks to engage in hedging, underwriting, and market-making-related activities using ownership interests in covered funds. The proposed changes do not comport with the statute, fail to meet the requirements of the APA, and would diminish important protections against bank losses arising from fund investments.

The Volcker Rule states that, despite its restrictions on proprietary trading, a banking entity may organize and invest in a hedge fund or private equity fund, but "only if," among other restrictions, the banking entity does not retain more than a "de minimis" investment not to exceed "3 percent of the total ownership interests" in the fund.[63] The 2013 regulations faithfully implement that part of the statute.[64]

The 2018 Proposed Rule would weaken the existing regulations by encouraging banking entities to acquire interests in hedge funds and private equity funds, not only through sponsoring and advising such funds, but also through hedging, underwriting, and market-making-related activities.[65] In particular, the Proposed Rule would allow banking entities to exclude from the calculation of the three percent limit the value of any ownership interest in a third-party covered fund acquired or retained through underwriting or market-making-related activities. In addition, the Proposed Rule would allow banking entities, for the first time, to purchase third-party covered fund ownership interests when acting on behalf of a client in order to expose that client to the fund's profits or losses. The Rule is unclear as to whether it intends also to exclude the value of those fund holdings – held on behalf of a client – when calculating the banking entity's three percent limit.

The Proposed Rule's attempt to undermine the effectiveness of the three percent limit is contrary to law, since the Volcker Rule explicitly establishes that numerical limit to restrict bank involvement with covered funds. It is inappropriate for the Proposed Rule to try essentially to increase the statute's numerical limit by proposing to exclude valuable holdings from the relevant calculations. In addition to being an inappropriate way to carry out the agencies' legal obligation to implement the law, the Proposed Rule fails to provide any evidence or broad-based data demonstrating that banking entities need to be able to trade covered fund holdings in order to perform hedging, underwriting, or market-making activities. In fact, the Proposed Rule offers no evidence or data of any kind to support the changes it is advancing.

The Volcker Rule places restrictions on the extent to which banking entities may invest in hedge funds and private equity funds not only to limit bank investments in what are typically high-risk activities, but also to prevent banks from evading the law's proprietary trading restrictions by carrying out prohibited trading activities through covered funds – doing indirectly what the banks are not permitted to do directly.[66] The 2013 implementing regulations appear to have successfully reduced the extensive investments that federally insured banks once held in private funds. At the same time, the regulations do not appear to have hampered bank vitality, given record levels of bank profits and lending. The evidence also indicates that large U.S. banks have been able to engage in a wide range of hedging, underwriting, and market-making-related activities without buying or selling interests in covered funds. The 2018 Proposed Rule offers no compelling justification for reversing course and once more increasing bank involvement with covered funds.

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[63] Volcker Rule, § 13(d)(1)(G)(iii) and (d)(4)(B)(ii).
[64] 2013 regulations at §§ __.10 and __.11(c).
[65] 2018 Proposed Rule at 33439, 33482-84.
[66] See, e.g., 2011 Merkley-Levin Harvard Essay, at 546.

In addition to the specific changes just discussed, the 2018 Proposed Rule poses numerous questions related to possibly changing the existing regulatory definition of covered funds, raising issues related to a variety of investment vehicles including foreign public funds, venture capital funds, joint ventures, and securitizations.[67] Each of the questions posed should be evaluated in light of the Volcker Rule's statutory objective of limiting bank involvement with private funds – not only to avoid risk, but also to prevent covert proprietary trading activities carried out through those private funds. In short, the point of the Volcker Rule and its implementing regulations is to limit, not facilitate, bank investments in private funds. To date, the Volcker Rule and the 2013 regulations have successfully protected U.S. taxpayers and the U.S. financial system from bank losses associated with high-risk funds. The Proposed Rule fails to provide any specific or broad-based data justifying the many possible changes it identifies, most of which would expand, rather than limit, bank involvement with private funds.

It is also important to note that, as with other provisions, the Proposed Rule fails to offer even basic factual data needed to evaluate the changes it is advancing. For example, the Proposed Rule fails to provide any data about the extent or duration of U.S. bank investments in private funds over the past four years, the number and types of funds attracting bank investment, or the risk profiles and losses experienced by different types of private funds over the past decade. The absence of this basic information is particularly perplexing, given the years of implementation data available to regulators under Appendix A of the 2013 regulations.

It would be contrary to law to roll back the Volcker Rule safeguards that limit bank involvement in high-risk hedge funds and private equity funds, and that prevent banks from using those funds to engage in covert forms of proprietary trading. Rolling back those safeguards or otherwise increasing bank involvement with private funds would not only contravene the statute and violate the APA, it would increase U.S. vulnerability to high-risk losses. Accordingly, the proposed changes should be rejected.

Expanding the Liquidity Management Exclusion

A sixth set of troubling provisions in the 2018 Proposed Rule involves its proposed expansion of a regulatory provision that, despite the statute's restrictions on proprietary trading, allows banking entities to engage in certain transactions designed to meet their liquidity needs. The proposed expansion is unnecessary and would invite high-risk covert proprietary trades. In addition, the proposed change does not comport with the statute, fails to meet the requirements of the APA, and would increase U.S. vulnerability to bank losses related to liquidity management.

As explained earlier, the Volcker Rule – like the Glass-Steagall provision after which it was modeled – generally prohibits banks from engaging in proprietary trading, but then permits banking entities to engage in a carefully circumscribed set of lower-risk, client-serving activities and limited hedge and private equity fund investments. The Volcker Rule also provides a

[67] 2018 Proposed Rule at 33472-82.

specific procedure for regulators to identify additional low-risk banking activities and deem them "permitted activities" under the law.[68]

Instead of using the procedure to identify additional permitted activities, however, the 2013 implementing regulations chose to create a series of exclusions from the definition of proprietary trading to allow banking entities to engage in certain activities that regulators viewed as unlikely to generate short-term profits for the bank. The activities encompassed within those exclusions, by definition, fall entirely outside the Volcker Rule and so are not subject to monitoring or supervision under its procedures to restrict proprietary trading. One such exclusion created in 2013, the so-called "liquidity management exclusion," permits banking entities to buy and sell "securities" to manage their liquidity needs in accordance with a documented liquidity management plan that meets certain requirements.[69] The permitted securities must be highly liquid and not reasonably expected to generate profits or losses from short-term price movements.

The existing liquidity management exclusion has no explicit statutory basis, which means it provides an unstable foundation for further expansion. Nevertheless, the 2018 Proposed Rule seeks to expand the exclusion by permitting banking entities to buy and sell, not just securities, but also foreign exchange forwards, foreign exchange swaps, and physically-settled cross-currency swaps to manage their liquidity needs.[70]

Multiple problems make this proposal unwise. First, the law's track record makes it clear that banking entities have been able to manage their liquidity needs under the existing exclusion using liquid securities resistant to short-term price movements. The U.S. banking industry has operated under that system for years and is both profitable and flourishing. The Proposed Rule offers no specific or broad-based data demonstrating problems with the status quo or supporting the proposition that America's largest banks also need to buy and sell foreign currency futures or swaps to manage their liquidity needs.

Second, foreign currency instruments are more likely to experience short-term price movements than the types of securities currently approved for liquidity management. Foreign currency exchange prices fluctuate on an often unpredictable basis and can create the very type of short-term price movements and trading temptations that the Volcker Rule was designed to keep federally insured banks from undertaking. While those volatile price movements may necessitate trading foreign currency instruments to hedge risk, they do not justify use of foreign currency instruments to manage bank liquidity. The 2018 Proposed Rule fails to acknowledge, much less examine, how short-term price movements affect foreign currency instruments or explain why such instruments should be used for liquidity management rather than hedging.

A third reason for caution is the banking industry's recent history of misconduct in handling foreign currency trades. Regulators have repeatedly charged global banks and their foreign currency traders with rigging foreign exchange rates to produce bank profits, leading to

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[68] See Volcker Rule, § 13(d)(1)(J).
[69] 2013 regulations at § __.3(d)(3).
[70] 2018 Proposed Rule at 33451.

widespread bank sanctions and massive fines.[71] Given that record of misconduct in the currency markets, the 2018 Proposed Rule fails to explain why regulators should give banks greater opportunity to use foreign currency transactions to manage their liquidity needs, especially when those needs are already being met on the securities markets.

It is also important to recall that, in 2013, federal regulators deliberately designed the liquidity management exclusion to allow banks to use only securities, rather than a broader set of financial instruments, in order to prevent banks from using the exclusion to engage in the type of portfolio trading, supposedly for hedging purposes, that led to the misguided London whale trades.[72] The 2013 regulations note explicitly that the final rule narrowed the scope of the liquidity management exclusion as first proposed in order to prevent banks from using the exclusion to engage in "asset-liability management, earnings management, or scenario hedging."[73] The 2018 Proposed Rule fails even to acknowledge, much less address, that set of concerns which drove the current structuring of the liquidity management exclusion.

In addition, as with other provisions, the Proposed Rule fails to provide critical factual data needed to assess the change it is advancing. It fails to provide, for example, information about the banks' liquidity needs and current liquidity management practices, the dollar value of securities currently used for liquidity management and the effectiveness of those securities in meeting banks' liquidity needs, the relative volatility and risk profiles of the permitted securities versus foreign currency instruments, or how the proposed change would affect current bank practices and the securities and currency markets. That type of basic factual information, which the APA requires to justify a regulatory change, is simply missing from the Proposed Rule.

Expanding the liquidity management exclusion to enable banking entities to trade in foreign currency markets to manage their liquidity needs would make it easier for America's largest banks to engage in proprietary trading disguised as liquidity management. The existing liquidity management exclusion – which itself has no statutory basis and should be reconstituted

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[71] See, e.g., "Timeline-The global FX rigging scandal," Reuters, Jamie McGeever (1/11/2017), https://www.reuters.com/article/global-currencies-scandal/timeline-the-global-fx-rigging-scandal-idUSL5N1F14VV; "5 big banks pay $5.4 billion for rigging currencies," CNNMoney, Virginia Harrison and Mark Thompson (5/20/2015), http://money.cnn.com/2015/05/20/investing/ubs-foreign-exchange/index.html.

[72] See, e.g., "U.S. Agencies Approve Final Volcker Rule, Detailing Prohibitions and Compliance Regimes Applicable to Banking Entities Worldwide," Sullivan & Cromwell (1/27/2014), at 33.

[73] 2013 regulations, Supplemental Information, 79 FR 21 (1/31/2014), at 5828 ("The Agencies have determined, in contrast to certain commenters' requests, not to expand this liquidity management provision to broadly allow asset-liability management, earnings management, or scenario hedging. To the extent these activities are for the purpose of profiting from short-term price movements or to hedge risks not related to short-term funding needs, they represent proprietary trading subject to section 13 of the BHC Act and the final rule; the activity would then be permissible only if it meets all of the requirements for an exemption, such as the risk-mitigating hedging exemption, the exemption for trading in U.S. government securities, or another exemption." Footnotes omitted.).

as a “permitted activity” under the law – should not be expanded in ways that would open the door to covert proprietary trading. The proposed change should be rejected.

Weakening Volcker Rule Safeguards at Multi-Billion-Dollar Banks

In addition to all of the changes just discussed, several sections of the 2018 Proposed Rule seek to reduce or eliminate key Volcker Rule safeguards at banks with various levels of trading operations. The proposed changes do not comport with the law or the APA. In addition, they would weaken Volcker Rule safeguards at massive, multi-billion-dollar banks across the country, and they would increase the vulnerability of the United States to another financial crisis fueled by proprietary trading.

Earlier this year, in response to lobbying by the banking industry, Congress enacted a new law which, among other provisions, amends the Volcker Rule to exempt from its coverage banks that meet two criteria: (1) their assets total less than $10 billion; and (2) their trading assets and liabilities do not exceed 5 percent of their total assets.[74] As a result, banks with up to $10 billion in total assets and up to $500 million in trading assets and liabilities can now operate without any Volcker Rule safeguards or data or compliance requirements.

The Proposed Rule states that it intends to conduct a separate rulemaking to implement the new law,[75] but nevertheless intends to proceed with establishing a three-tiered definition of trading operations subject to the Volcker Rule as well as reduced regulatory requirements for certain classes of banks, creating a complex regulatory framework that deviates substantially from what Congress has authorized. Under the Proposed Rule’s new three-tiered approach, banking entities would be defined as having “significant” trading operations if they have $10 billion or more in trading assets and liabilities, while banking entities would be defined as having “moderate” trading operations if they have between $1 billion and up to $10 billion in trading assets and liabilities, and “limited” trading operations if they have less than $1 billion in trading assets and liabilities.[76] The rule states that each defined class would be subject to different regulatory and compliance requirements under the Volcker Rule, with the most stringent requirements applying to banks with significant trading operations.[77] At the same time, outside of the proposed definitions, several provisions in the Proposed Rule seek to establish reduced regulatory requirements for banks with less than $50 billion in assets and liabilities, a class of trading operations not even mentioned in the three-tiered approach.[78]

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[74] Economic Growth, Regulatory Relief, and Consumer Protection Act, S. 2155, § 203, P.L. 115-174 (5/24/2018).
[75] Proposed Rule at 33434.
[76] Id. at 33446 (proposing three-tiered definition).
[77] Id. at 33440.
[78] See, for example, 2018 Proposed Rules at 33458-59, 33462 (proposing to “eliminate the … compliance program requirements” related to underwriting and market-making-related activities for all banks with less than $50 billion in trading assets and liabilities) and 334566 (proposing to “eliminate” a host of compliance and operating requirements related to hedging activities at banks with less than $50 billion in trading assets and liabilities).

The Proposed Rule's three-tiered framework would vary substantially from its statutory authority, not only under the 2010 Volcker Rule, but also under the 2018 law. The 2010 Volcker Rule broadly prohibits proprietary trading by U.S. banks, and nowhere mentions a three-tiered or four-tiered approach to compliance obligations for covered banks. Under the 2018 law, the largest bank allowed to operate free of Volcker Rule safeguards must report less than $10 billion in total assets and less than $500 million in trading assets and liabilities. In contrast, the Proposed Rule would essentially eliminate Volcker Rule requirements for banks with up to $1 billion in trading assets and liabilities, a figure twice as large as what Congress just enacted. Even more out of alignment with the new law is the Proposed Rule's provisions seeking to eliminate all or most Volcker Rule hedging, underwriting, and market-making-related safeguards at banks with up to $50 billion in trading assets and liabilities – an amount 10 times larger than the figure just established by Congress. And none of the 2018 proposals places any limit at all on a bank's total assets.

In light of the newly enacted $500 million ceiling on trading assets and liabilities and $10 billion ceiling on total assets to determine which banks may avoid Volcker Rule safeguards, the Proposed Rule's three-tiered approach to categorizing trading operations and its reduction of Volcker Rule safeguards at various classes of banks (including those with up to $50 billion in trading assets and liabilities) should be withdrawn, reconsidered, and redesigned to align with the 2018 law. Moreover, the proposals to reduce regulatory requirements for banks with up to $50 billion in assets and liabilities should be scrapped altogether, not only because the selected figure has no evidentiary support and is significantly out of alignment with current law, but also because the proposals would dramatically increase U.S. vulnerability to proprietary trading losses at multiple banks across the country.

Eliminating Appendix B

A final ill-considered provision in the 2018 Proposed Rule seeks to eliminate Appendix B from the 2013 regulations.[79] Appendix B currently requires large banking entities to maintain an identifiable Volcker Rule compliance program meeting certain enhanced minimum standards.[80]

Eliminating Appendix B would permit large banking entities to merge their Volcker Rule compliance programs into their other compliance programs, making it more difficult for Congress, regulators, and the public to understand what banks are doing to comply with the law's restrictions on proprietary trading. Since U.S. banks have already established their Volcker Rule compliance programs under Appendix B, the spending on the infrastructure needed for that compliance effort has already taken place. The 2018 Proposed Rule offers no detailed supporting evidence, much less a compelling justification, for dismantling the existing approach, rendering past bank expenditures meaningless, or making future Volcker Rule compliance efforts more difficult to monitor and evaluate. The proposed deletion of Appendix B should be rejected.

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[79] 2018 Proposed Rule at 33439, 33488, 33490-94.
[80] 2013 regulations, § __.20(c), Appendix B.

Conclusion

The provisions discussed above present only the most egregious problems with the 2018 Proposed Rule. Due to those and other deficiencies, the entire proposal should be withdrawn. At a minimum, the provisions discussed in this letter should be excised from any final rule.

Due to their relevance to this rulemaking process, this letter requests that the hearing records associated with the Senate examinations of the financial crisis and London whale trades, as well as the Merkley-Levin Harvard essay, all cited in the footnotes above, be included in the administrative rulemaking record, as well as in the record of any subsequent related proposed rule or guidance, and considered during the course of the rulemaking process.

Thank you for considering these comments.

Sincerely,

Elise J. Bean
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U.S. Senate Permanent Subcommittee on Investigations