



February 13th, 2012

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RIN 7100 AD 82

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Docket No. OCC-2011-0014

Re: Prohibition on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds

Dear Ladies and Gentlemen:

Better Markets, Inc.¹ appreciates the opportunity to provide comments to the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency (collectively “the Agencies”) in response to the request for public comment in connection with Notice of Proposed Rulemaking (“Proposed Rule”) published on October 11th, 2011, in connection with the “Volcker Rule” required under §619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

The Volcker Rule is narrow in application and limited in scope: it only applies to a 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, the Rule 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.

The Volcker Rule’s prohibition is also narrowly targeted at a particularly pernicious, dangerous and, indeed, lethal type of bank behavior: proprietary trading where banks place

¹ Better Markets is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular in the rulemaking process associated with the implementation of the Dodd-Frank Act.

huge bets with borrowed money that promise enormous upside, but risk even greater downside. This type of conduct, a key reason for huge losses 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. 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 trading and investment activities.

Notwithstanding one of the most comprehensive disinformation campaigns in modern history, implementing the Volcker Rule is not complex or difficult. The keys are:

1. breaking links between proprietary trading and banker bonuses,
2. backing up the law with swift, certain, and significant penalties for traders, supervisors and executives,
3. eliminating unstable funding methods used by bank broker dealers, and
4. requiring hedging congruence.

If the link between proprietary trading and banker bonuses is removed, then the incentive to proprietary trading will be gone. This can be readily accomplished by requiring that all compensation for the permitted activity of market making be limited to the historic and well known 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 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. That is what happened at

MF Global. Wall Street cannot really be saying that their trading books are like MF Global's. However, that is the logic of the principal argument being made against the Volcker Rule.

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.

As discussed further below, the risks created by the high leverage, liquidity-maturity mismatch funding model used by broker dealers must be changed and the permitted activity of risk mitigating hedging has to be tightened. Underpinning and reinforcing all the reforms in the Rule is the elimination of conflicts of interest between the banks and their customers and counterparties, which were and are shockingly rampant.

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.) or, put another way, gaining the benefits of avoiding such a crisis, are why it is so important to implement the Volcker Rule as intended. Imagine what would have happened if, in 2007-2008, the biggest banks didn't have any proprietary positions or inventory. Simply put, they would not likely have failed and multi-trillion bailouts would not likely have been necessary. That was, after all, what happened when the tech stock market bubble popped in 2001.

If the Volcker Rule is implemented as proposed here, that scenario will not have to be imagined. It will be the reality. The biggest banks will either not fail or, if they do, they will be able to do so without systemic implications, just as MF Global did recently.

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INTRODUCTION

Why the Volcker Rule is essential for a safe, sound and stable financial system that is less prone to crisis, failure, and bailouts

The ban on proprietary trading by banking entities, which is part of Section 619 of the Dodd-Frank Act, was included to address a significant problem. During the financial crisis, proprietary trading produced significant losses at large bank holding companies. These losses threatened the safety and soundness of the holding companies, disrupted important parts of the financial system threatening its stability, and required massive federal government rescue efforts to contain the effects on the financial system and the real economy.

The proprietary trading ban was written to remove these risks from institutions that are central to the payment and credit system. It is also intended to eliminate any taxpayer subsidy of high-risk, speculative trading. That subsidy derives from the fact that holding company profits are improved because their commercial bank subsidiaries have access lower cost funds through insured deposits, and in the case of banks that are viewed as “too big to fail” through lower borrowing costs.

The scope of the problem has been widely recognized. In early 2009 the Basel Committee on Banking Supervision summed up the damage, noting that:

“[s]ince the financial crisis began in mid-2007, the majority of losses and most of the build-up of leverage occurred in the trading book. Losses in many banks’ trading books during the financial crisis have been significantly higher than minimum capital requirements under the Pillar 1 market risk rules.”²

By eliminating proprietary trading losses at banks, major threats to institutions that are central to the credit and payments system would be eliminated. Balanced against entirely speculative and unquantified claims of reductions in the supply of market making, the restrictions on the Volcker Rule provide a clear benefit to society, if not to banker income.

The Senate Committee Report that accompanied the Dodd-Frank Act sums up the issue very cogently:

“[t]he incentive for firms to engage in these activities is clear: when things go well, high-risk behavior can produce high returns....When losses from high-risk activities are significant, they can threaten the safety and soundness of individual firms and contribute to overall financial instability. Moreover, when the losses accrue to insured depositories or their holding companies, they can cause taxpayer losses.”³

² Joint FSF-BCBS Working Group on Bank Capital Issues (2009). Reducing procyclicality arising from the bank capital framework, March, 3. *See also* Basel Committee on Banking Supervision (2009). Guidelines for computing capital for incremental risk in the trading book, July, 1 (“The decision was taken in light of the recent credit market turmoil where a number of major banking organizations have experienced large losses, most of which were sustained in the banks’ trading books.”).

³ S. Rept. 111-176, 111th Cong., 2d Sess. 7 and 74 (2010) to accompany S. 3217, April 30, 2010, available on the website of the Senate Committee on Banking, Housing, and Urban Affairs at http://banking.senate.gov/public/files/Comittee_Report_S_Rept_111_176.pdf

The collapse of Citigroup illustrates the risks that arise from proprietary trading

The damage inflicted on Citigroup by its broker dealer subsidiary vividly illustrates the threat that proprietary trading posed 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.⁴

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 at the prices Citi was offering. But instead of offering the securities at a market-clearing price – which would have required lowering the rates paid on the other CDO securities and thereby reducing their price – the Citigroup traders continued to create Super Seniors and to hold them in the bank’s inventory. They would only have created and held unsalable Super Senior securities to maximize their overall returns.⁵

To boost the return from their proprietary trade in the Super Senior positions, Citigroup used leverage. During 2003 and early 2006, Citigroup financed \$25 billion in Super Senior securities through conduits. These special purpose vehicles 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. Liquidity guarantees meant that third party purchasers of the commercial paper faced default risk only if Citigroup 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 to Citigroup’s proprietary trading positions. Since these securities were not sold in the market,

⁴ 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 Comptroller of the Currency estimates that 70 percent of the assets underlying Citigroup CDOs 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>

⁵ 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.” Ibid.

traders could assign potentially non-market values to the inventories they held. Because the securities were held in the trading account, little or no capital was required to back them.⁶ So the bank was fully exposed to any losses on the trading account inventory, with no significant regulatory constraint on the risk they were accumulating.⁷

By late 2007 it could no longer be denied that the Super Senior securities were worth far less than their face value.⁸ 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.⁹ 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.”¹⁰

By the end of 2008 Citigroup had written off \$38.8 billion related to these positions and to asset-backed securities and CDO securities it held in anticipation of constructing additional CDOs.¹¹

These losses dramatically reduced Citigroup’s capital, helped to bring the company to the brink of failure, and made a federal rescue necessary. The amount of federal help required to prevent Citigroup from failing was stupendous, including capital injections, debt guarantees, and asset guarantees.¹²

⁶ Financial Crisis Inquiry Commission (2011). Final Report of the Financial Crisis Inquiry Commission, U.S. Government Printing Office, 196-197.

⁷ Moreover, since the securities had been rated AAA by the credit rating agencies, they were eligible collateral for repo financing. Hence the Super Senior positions may have been financed through sources that could disappear literally overnight.

⁸ As soon as the credit rating agencies issued downgrades of subprime MBS in July 2007, every CDO security was obviously in some kind of trouble. Since, as was noted, the Citi CDOs were 70 percent subprime MBS -- and this usually meant securiteis rated BBB or lower -- its traders must have recognized in July 2007 that the Super Seniors would lose value.

⁹ 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

¹⁰ Federal Reserve Bank of New York (2008). Summary of Supervisory Activity and Findings for Citigroup, January 1, 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>

¹¹ See Citigroup, Inc., Form 10K for the period ending December 31, 2007, 48; Form 10K for the period ending December 31, 2008, 68.

¹² See Special Inspector General for the Troubled Asset Relief Program (2011). Extraordinary Financial Assistance Provided to Citigroup, Inc., January 13.

Citigroup was also the heaviest user of the Fed's Term Securities Lending Facility ("TSLF"), and a very heavy user of the Fed's 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 claimed "investment grade" collateral averaging \$3.7 billion each, are clear signs that its broker dealer was, at best, in a very distressed financial condition, if not insolvent. (see Appendix I, below).

The collapse to the brink of bankruptcy of Citigroup is merely illustrative of the harm that bank proprietary trading produced and threatened to produce throughout the entire industry. In confirmation of that, the heaviest users of TSLF and PDCF funds included several other bank-based broker dealers, among them Bank of America, Deutsche Bank, Credit Suisse and Barclays. (see Appendix I, below). Although they did not create wreckage on the scale of Citigroup, they were clearly on the brink of doing so and they all would have almost certainly failed but for the massive federal rescue programs and efforts.

How the Proposed Rule must be strengthened

Given the important causal role that bank proprietary trading played in the financial crisis, the rule that implements Section 619 is extremely important to the overall effort to prevent future financial crises. For that reason the Proposed Rule must be strengthened in several ways:

- The source of market maker income must be limited to spread, fees, and commissions to remove the incentive to engage in disguised illegal proprietary trading
 - Market makers earn their income from spread, fees, and commissions. So the rule should presume that only trading activity compensated from spread, fees, or commissions is market making. Otherwise taking high-risk speculative positions can still produce large rewards when successful.
- The enforcement provisions of the Proposed Rule must be strengthened if the rule is to be effective and the law complied with
 - Expected profit from proprietary trading should be eliminated through the imposition of financial penalties on traders, supervisors, executives, and firms that significantly exceed the gains or losses from the proprietary position. Otherwise, breaking the law will be viewed as merely a cost of doing business, particularly if traders conclude that on average it is worthwhile to take the risk of being detected.
 - In addition to being illegal, repeated instances of proprietary trading increase the risk to the bank and to the financial system, and therefore require heightened prudential standards for the violator bank. When per

violation penalties do not deter violations, additional disincentives are necessary to deter risk to the financial system.

- The risks created by the high leverage, liquidity-maturity mismatch funding model used by broker dealers must be removed
 - Tough leverage restrictions and liquidity requirements are necessary to limit threats to banks and financial stability from permitted trading activity, and from otherwise undeterred proprietary trading. If bank broker dealers pursue their historic patterns in leverage and funding, their trading operations will remain subject to destabilizing runs.
- Requirements for permitted risk-mitigating hedging need to be strengthened
 - Any risks created by a hedge should be extremely small in relation to the primary risk that is being hedged, and must not contain potential “time-bombs” such as extreme convexity.
 - Supervisors who approve hedges must attest that they conform to the requirements for risk-mitigation
- The Proposed Rule impermissibly weakens the statutory requirement that permitted transactions not create conflicts of interest with bank clients, customers and counterparties
 - The Proposed Rule allows conflicts if they are adequately disclosed, but this is inconsistent with the language of the statute and must be changed.

Why criticisms of the rule lack merit

In section F below, we address some criticisms of the Volcker Rule that have recently received significant attention. We show that claims that restrictions on bank trading will permanently remove important market making capacity and impose high net costs on the economy are not supported by convincing economic reasoning or empirical evidence. We also show that concerns about the liquidity of markets for foreign sovereign debt are misplaced.

COMMENTS

A. Trading income must be limited to spread, fees, and commissions to remove the incentive to engage in proprietary trading

(1) The Proposed Rule preserves incentives to disguise proprietary trading as market making

The prohibition on proprietary trading in Section 619 of the Dodd-Frank Act is absolute. Other than trading in certain government securities, there are no exceptions.¹³ The statute does explicitly permit five types of non-proprietary trading activity by banking entities: (1) market making, (2) risk-mitigating hedging, in connection with and related to the holdings of the banking entity, that is designed to reduce the risk of those holdings, (3) underwriting, (4) trades on behalf of customers, and (5) trades in certain government securities.

A principal difficulty in implementing Section 619 by rule is that the classification of market making as a permitted activity could create an opening for disguised proprietary trading. Market makers are intermediaries who stand ready to buy or sell some financial instrument, and who make their income from the difference between the prices at which they offer to buy and sell (the bid-ask spread), or from fees and commissions.¹⁴ Market makers in a competitive market will set their charges to customers at a level that will cover the costs of executing transactions, holding positions, and bearing risk.¹⁵ Proprietary traders, in contrast, take positions in a financial instrument to profit from price changes and not to meet the needs of their customers. They may buy and sell frequently, but they are not in the business of market making.

The distinction between holding inventory as a market maker and taking a proprietary position is explicitly recognized in the statute, which permits:

“[t]he purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) in connection with underwriting or market-making-related activities, to the extent that any such activities permitted in this subparagraph are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties.” [emphasis added]

By referring to “near term” demands, the statute acknowledges that a market maker may have an inventory of financial instruments that they are about to sell. But it also makes clear that position taking, however disguised – think of the creative tactics by which the Citigroup traders stuffed Super Senior CDO securities onto the holding company balance sheet – is no longer allowed.

¹³ Dodd-Frank Act Sec. 619 (a)(1), 619 (d)(1). See also, Better Markets November 5, 2010 Comment Letter, pages 3-5 in particular, available at <http://www.bettermarkets.com/sites/default/files/FSOC-%20Comment%20Letter-%20Volcker%2011-5-10.pdf>, incorporated as if fully set forth herein (“Better Markets’ Volcker Rule Comment Letter”).

¹⁴ Section 619(13)(d)(1)(B)

¹⁵ See L. Harris (2003). *Trading and Exchanges: Market Microstructure for Practitioners*, Oxford: Oxford University Press, 401-402; P. Shen and R. Starr (2002). Market-makers supply and pricing of financial market liquidity. *Economics Letters*, 76, 53-58 (and the references therein).

However, since both market makers and proprietary traders can hold positions, a firm or person seeking to engage in proprietary trading could claim to be engaged in market making that just happened to produce capital gains or losses. Since successful proprietary trading positions can produce large speculative gains and bonuses for traders, traders at banks have a powerful incentive to exploit this opening and evade the prohibition on proprietary trading.

The Proposed Rule approaches the problem created by the permitted activity of market making by identifying a large set of metrics which bank trading units must report to their regulators. The set includes measures of risk taking, sources of revenue, risk taking relative to revenue, degree of customer-facing activity, and payment of spread, fees, and commissions. These metrics will be used, after the fact, to distinguish between market making and proprietary trading. With respect to compensation – **the main incentive for any trader and/or bank to evade the ban on proprietary trading** – the rule states that:

“[a]bsent explanatory facts and circumstances, the trading activity of a trading unit that provides compensation incentives to employees that **primarily reward** proprietary risk taking will be considered prohibited proprietary trading, and not permitted market-making-related activity. [The Agency] will base such a determination on all available facts and circumstances, including, among other things, an evaluation of: the extent to which compensation incentives are provided to trading unit personnel that reward revenues from movements in the price of retained principal positions and risk; the extent to which compensation incentives are provided to trading unit personnel that reward customer revenues; and the compensation incentives provided by other banking entities to similarly-situated personnel.”¹⁶ [emphasis added]

This part of the rule is apparently written so that firms can give traders incentives to minimize inventory costs, by allowing compensation to be tied to overall gains and losses on unit revenues. But at the same time it preserves avenues through which traders can be rewarded for successfully taking speculative positions, which by definition are against the law. For example, under this rule a successful trading year might be rewarded by much higher trader “salaries” in the following year, paid from this year’s trading profits, rather than through the payment of year-end bonuses tied to individual trading performance. And as long as traders can get significant rewards for swinging for the fences, they are likely to do so.

(2) The source of market making income must be limited to spread, fees, and commissions

There is a much more direct way to address this trader incentive problem and dramatically increase compliance with the law. Market makers earn their income from spread, fees, and commissions. So the rule should presume that only market making activity compensated from spread, fees or commissions is market making. Market making activity compensated in any other manner should be prohibited. This means that a trader who took

¹⁶ [Federal Register](#), Vol. 76, No. 215, 68963.

a successful speculative position would not share in the gains. A crucial element of the incentive structure that currently motivates proprietary trading would be eliminated.

Restricting the **source** of compensation to spread, fees, and commissions will not prevent a bank from aligning trader incentives with the goal of profit maximization. The actual compensation to traders from this revenue source could be made a function of the overall profitability of the trading unit.

There is a readily available way to police this compensation rule: the bonus pool. 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 (weekly, monthly, quarterly, 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 and desk who will be fighting for the largest bonus possible based on their claimed contribution to the firm's profits (and/or other bonus components).

Using existing documentation, reverse engineering the bonus pool 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.

(3) The agencies should recognize that High Frequency Trading is not market making.

When applying the rule to the permitted activity of market making, regulators should not confuse high volume trading strategies with market making. Many firms, including banks, use computer executed algorithms as part of their trading strategies. A particular form of algorithmic trading called High Frequency Trading (HFT) has in recent years become a highly profitable source of proprietary trading for large banks.¹⁷

However, a trading strategy is not in itself market making. Algorithmic traders in general and HFTs in particular do not hold themselves ready to buy or sell the financial instruments they trade. On the contrary, they offer to buy or sell only when they believe there are profits to be made by doing so. These traders can and do walk away from markets when it is in their interest.

Therefore, HFT and algorithmic traders are not market makers and are not engaged in the permitted activity of market making. Put another way, HFT and algorithmic trading are proprietary trading, which is banned at banking entities covered by Section 619.

B. The enforcement provisions of the Proposed Rule must be drastically strengthened to help prevent evasion

The enforcement provisions of the Proposed Rule are minimal and grossly insufficient to obtain compliance with the law. They must be strengthened and clarified, or widespread

¹⁷ See, e.g. Associated Press, "Citigroup to expand electronic trading capabilities by buying Automated Trading Desk" <http://archive.upstatetoday.com/?p=6015>

violations of the law by traders and firms are all but guaranteed and the purpose of the law will be defeated.

The Proposed Rule merely states that when proprietary trading is found, the bank can be ordered to “restrict, limit or terminate the activity and, as relevant, dispose of the investment.” This empty provision will be quickly seen for what it is and will not deter proprietary trading: if the trade is detected, the bank **may** be told to stop proprietary trading, and **may** be required to unwind proprietary trades that are still on its books. That is not an enforcement provision, it is an option that may or may not be exercised if the illegal conduct is detected, itself highly unlikely.

In other words, the Proposed Rule tells the market that the consequences of a detected violation are likely to be very small. Moreover, the bank and its traders will keep any winnings from successful but undetected trading. Thus, the Proposed Rule will incentivize and reward breaking the law and allow proprietary trading to again threaten the safety and soundness of the banks and the financial system.

(1) Expected individual profit from proprietary trading must be eliminated through the imposition of adequate financial penalties

Of course, even after limiting the source of trader compensation to spread, fees, and commissions, it might be possible for a firm to disguise the payment of rewards to proprietary trading, perhaps through promotions following a successful year of proprietary trading, or through indirect forms of compensation. If the **expected** monetary gain from evading the prohibition is significant, net of enforcement penalties, then traders and firms will have an incentive to evade.

Therefore the proposed enforcement rules need to be revised to clearly and unequivocally reduce the expected gains from evasion and breaking the law. **Given that the probability of detection is less than one**, a meaningful ex-post enforcement program must have financial penalties that are some **multiple** of the gain from violating the rule. Otherwise, the rationally expected return on illegal proprietary trading will be positive, giving a clear incentive to violate the law. Moreover, the financial penalties should be paid by the individuals who gain from a violation and the supervisors and executives responsible for ensuring that such activity does not happen. Otherwise the burden of the penalty can be shifted by the beneficiaries to the bank stockholders.

At a minimum the enforcement provisions of the Proposed Rule should state that the Federal Reserve will use its full authority under Section 8 of the Bank Holding Company Act to create 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.

Given the huge potential rewards for violating the law and engaging in disguised proprietary trading, anything less than equally severe penalties will be insufficient to obtain the necessary compliance. The downsides have to be multiples of the potential upside to affect the rational trader's calculus.

In addition, 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.¹⁸

To the extent possible, the enforcement authority of the Securities and Exchange Commission and the Commodity Futures Trading Commission should be used to complement and amplify actions that are taken under the authority of the Bank Holding Company Act.

(2) Repeat instances of proprietary trading indicate heightened risk to the bank and to the financial system, and require heightened prudential standards for the bank

If a bank violates the prohibition on proprietary trading more than once, that is clear evidence that the penalties to deter individual behavior are insufficient. It is also a sign that a bank may be engaged in long term evasion of the prohibition, thereby creating risks to the bank and the financial system. Regulators have the authority to address the threats flagged by repeat violation, and they must use it.

Section 619(d)(3) gives regulators authority to impose:

“additional capital requirements and quantitative limitations, including diversification requirements, regarding the activities permittedif [they] determine that additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking activities engaged in such activities.”

Section 165 of the Dodd-Frank Act gives the Federal Reserve authority to impose enhanced prudential requirements, including those related to capital, liquidity, and leverage, on large bank holding companies in order to prevent and mitigate risks to financial stability.

Federal regulators must use this authority to further reduce the incentives for proprietary trading at violator banks. By increasing capital and liquidity requirements, restricting leverage, and setting other quantitative limits, they can increase the cost of engaging in proprietary trading, while enhancing the safety and soundness of the bank.

¹⁸ See also Better Markets' Volcker Rule Study Comment Letter, cited in note 13 herein above, pages 6-7 in particular.

C. Because the broker dealer funding model creates unacceptable risk to banking entities and financial stability, the Proposed Rule must include strong leverage limits and liquidity requirements for trading activities

(1) Permitted bank trading must be subject to strong leverage and liquidity requirements

Although Section 619 specifically permits a few enumerated non-proprietary trading activities, such as market making, from the prohibition on proprietary trading, even those few permitted activities are qualified. In particular, subsection 619(d)(2)(A) removes the permitted status of any activity that:

“

- (ii) would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as such terms shall be defined by rule as provided in subsection (b)(2);
- (iii) would pose a threat to the safety and soundness of the banking entity; or
- (iv) would pose a threat to the financial stability of the United States.”

Events of the financial crisis have demonstrated that the financial model still used by bank broker dealers is highly unstable and poses significant threats to bank safety and soundness, and to overall financial stability.

As demonstrated in detail in subsection (2) below, broker dealers historically have been highly leveraged, willing to depend on repo and other short term borrowing to fund longer maturity and less liquid assets, and subject to fatal lender runs in times of stress. These weaknesses required the Federal Reserve to create the TSLF and PDCF to bail out the broker dealers during the crisis. That bailout is also discussed in detail in subsection (2) below.

Because of the demonstrated threat posed by the broker dealer funding model, any rule implementing Section 619 needs to address its weakness directly. By doing so the rule would decrease the likelihood that otherwise undeterred proprietary trading would create significant threats to a bank or to overall financial stability. Unfortunately the Proposed Rule does not do so. Instead, it merely restates Section 619(2)(A) in slightly altered form.

What the rule must do is place meaningful leverage and liquidity requirements on bank broker dealers. The lower the permitted leverage, the smaller the impact of an asset price decline on the equity of any one trader. The higher the liquidity requirements, the less likely that an asset price decline would result in a forced asset sale.

It must be recognized that unless leverage and liquidity requirements are very tough, the very serious threats created by bank trading operations – which materialized in 2008 – will persist. Runs by bank depositors are not deterred by fractional capital requirements alone, because depositors know that they can take losses if the bank’s assets lose sufficient value. Depositor runs are prevented by deposit insurance, which assures depositors that they will not lose by continuing to fund the bank.

But there is, at the moment, nothing analogous to deposit insurance for repo lenders. So it is entirely predictable that in a period of market turmoil repo lenders will reduce the acceptable leverage ratio for assets they fund from fifty to two, or exit the repo market altogether, at a moment's notice, just as they did during the financial crisis. Therefore, to meet the requirements of 619(d)(2)(A) the Proposed Rule must mandate low leverage and high liquidity for bank broker dealers.

(2) Crisis events have demonstrated that highly leveraged trading positions supported by repo borrowing are unstable and can produce large shocks to the financial system

(a) Broker dealer use of repo financing

Repo borrowing is an important source of funding for broker dealers. The 19 U.S. primary dealers, which is a subset of all repo market borrowers, reported repo financing of \$4.5 trillion in fixed income securities on March 4, 2008.¹⁹ It has been estimated that in mid-2008, the (then) five largest broker dealer/investment banks collectively financed 42 percent of their assets through repo borrowing.²⁰

Repo allows a borrower to become highly leveraged. In a repo transaction the asset serves as collateral for the loan. So the borrower needs to provide equity funding for the asset only to the extent that the lender insists that the value of the collateral exceed the value of the loan. These repo "haircuts" can be very low. Haircuts for private label mortgage-backed securities ("MBS") and corporate bonds were estimated to be 3-4 percent in 2007 in the tri-party repo market.²¹ In the bilateral dealer bank market, haircuts on unpriced and subprime MBS and corporate bonds are estimated to have been zero in the first half of 2007.²²

When haircuts are low – as they were for highly-rated subprime MBS and many other types of securities in early 2007 – it is possible to obtain very high leverage (at relatively low short-term interest rates) to support a trading position in assets with long maturities. The high leverage of the large broker dealers is explained in significant part by their use of repo borrowing as a source of debt finance.

Positions that are financed using very short-term borrowing create the potential for a rapid run by the lenders. Repo funding is cheap because any individual lender can change the rate and collateral requirements of a loan very quickly, or simply decide not to roll it over, when a borrower or an asset class becomes less desirable to them. But when things go wrong and lenders as a group decide against a borrower or the collateral he holds, that borrower can see his repo funding vanish in short order. A significant increase in haircuts, for example, means that the borrower must have adequate equity to cover the lost financing, or sell off the position.

¹⁹ G. Gorton and A. Metrick (2010). Securitized Banking and the Run on Repo, 12. Available at <http://ssrn.com/abstract=1440752>.

²⁰ M. King (2008). Are the brokers broken? Citibank Global Markets Ltd.

²¹ A. Krishnamurthy et al. (2011). Sizing Up Repo, 27.

²² G. Gorton and A. Metrick, op. cit., Table II, Panel D.

If the borrower has used repo to create significant leverage, a run on repo can spell disaster. If the assets he has supported are illiquid or have declined in value, he can be forced to recognize losses and perhaps become insolvent. And of course there may be spillover effects to other firms and to repo financing in general. These dynamics were very important during the financial crisis.

(b) Runs on repo financing during the crisis

Once it became clear that there would be large losses on subprime and other non-Agency MBS in mid-2007, repo runs soon followed. There is evidence that non-Agency ABS and MBS securities – which were used as collateral in the tri-party repo market by several large broker dealers prior to the crisis – ceased to be acceptable repo collateral as the financial crisis intensified. This hit particular dealer banks especially hard.

According to Krishnamurthy et al.²³:

“While the repo contraction on non-Agency MBS/ABS appears small for the shadow banking system, we find evidence that it played a more significant role for some dealer banks. For Merrill Lynch, Goldman Sachs, Morgan Stanley and Citigroup, nearly 50% of the [tri-party] repo transactions with [money market funds] prior to the crisis were backed by non-Agency MBS/ABS and corporate debt, and almost all of this repo from [money market funds] disappears in the crisis.”

In the bilateral repo market – where secured loans are made between large financial institutions with no intermediary – there is evidence of a huge increase in haircuts for a wide range of non-Treasury assets after the middle of 2007. By one estimate the average haircut rose from zero in the beginning of 2007 to 45 percent by the beginning of 2009.²⁴ Many bilateral repo borrowers are hedge funds and other firms seeking cash from the prime brokerage operations of broker dealers. However, dealers also fund themselves through this market.²⁵ So the rise in haircuts had an impact on leveraged dealer positions.

The liquidity crises and dramatic failures of Bears Stearns and Lehman Brothers were in significant measure caused by the disappearance of repo financing on which they were heavily dependent. In the run-up to their respective failures, various tri-party repo counterparties cut their exposures, required larger haircuts and higher interest rates, and ultimately ceased dealing with them.²⁶ The bilateral repo market also turned against Bear Stearns and contributed to its demise. According to the Financial Crisis Inquiry Commission report, repo lenders to two Bear Stearns internal hedge funds increased collateral haircuts or refused to roll over their loans before the funds filed for bankruptcy on July 31, 2007.²⁷

²³ A. Krishnamurthy et al., *op. cit.*, 4.

²⁴ G. Gorton and A. Metrick, *op. cit.*, 20-21.

²⁵ T. Adrian et al. (2012), *Repo and Securities Lending*, Federal Reserve Bank of New York, Staff Report No. 529, December, 4-5.

²⁶ Financial Crisis Inquiry Commission (2011). [Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States](#). Government Printing Office, 280-91, 324-31; D. Duffie (2010), *The failure mechanics of dealer banks*, Bank for International Settlements, Working Paper No. 301, March, 16; A. Copeland et al (2010), *The tri-party repo market before the 2010 reforms*, Federal Reserve Bank of New York, Staff Report No. 477, November, 55-63.

²⁷ *Ibid.*, 239-243.

(c) The Federal Reserve was forced to support broker dealers to stem the run on repo financing

The Federal Reserve was so alarmed by the crisis in the repo market that it established two separate rescue facilities. The Primary Dealer Credit Facility provided overnight repo financing to primary dealers for tri-party eligible collateral. The Term Securities Lending Facility provided 28-day swaps of tri-party-eligible collateral for Treasury securities. The Treasury securities then could be used as collateral for repo borrowing.

Both these facilities were widely used by very large broker dealers, including those housed in major banks. Summary data on broker dealer borrowing from the PDCF and TSLF— which show large scale borrowing by several important broker dealers – are presented in Tables 1 and 2 [see Appendix I, below]. Borrowing from the TSLF was highly correlated with broker dealer financial weakness – as measured by leverage and cumulative stock price declines.²⁸

D. Requirements for permitted risk-mitigating hedging need to be strengthened

(1) Hedges must be congruent to the positions they are meant to hedge

Section 619 includes as a permitted activity “Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts, or other holdings.” The Proposed Rule addresses this provision of the statute in §__.5.²⁹

The implementation of this provision is critical to the success or failure of the section as a whole: done wrong, it could create huge loopholes for illegal proprietary trading to take place under the guise of “hedging.” In a letter to the CFTC on the topic of the end-user exception to mandatory clearing of swaps, Better Markets pointed out that a principle of congruence is needed to ensure that “hedging” is not used to disguise speculative trading.³⁰ The same logic that applies to end-user exemptions applies to dealers hedging risk: hedges must be congruent to the positions they are meant to hedge.

In its strongest form, the principle of congruence states that no new risks should be created by a hedge: it should be purely risk-reducing, not risk-creating. In practice, a perfect hedge often does not exist. Therefore, the weaker version of the principle of congruence says that any risks created by a hedge should be **extremely small** in relation to the primary risk that is being hedged, and should not contain potential “time-bombs” such as extreme convexity.

²⁸ Archaya et al. (2011). Dealer Financial Conditions and the Term Securities Lending Facility: Was Bagehot Right After All?, December 29, 5.

²⁹ Release at 68948

³⁰ Better Markets Comment Letter on End-User Exception to Mandatory Clearing of Swaps, February 22nd 2011, available at <http://bettermarkets.com/rulemaking/better-markets-comment-letter-end-user-exception>, which is incorporated herein as if fully set forth.

This criterion should be applied across the board, with no exceptions. A claimed “hedge” that is not congruent with the position it is supposed to hedge is not a hedge, but an instance of proprietary trading.

The Proposed Rule rightly embodies the principle of congruence at a basic level. They state that hedges must be “reasonably correlated” in terms of risk and liquidity to the position they are intended to hedge.³¹ Further, a hedge must not “give rise, at the inception of the hedge, to significant exposures that were not already present...and that are not hedged contemporaneously.”³² The rules must certainly not be weakened from this starting point – “reasonably correlated” is a minimum standard of congruence. Additionally, they should be strengthened with respect to their treatment of convexity.

The Proposed Rule stipulates that a permitted hedge must be reviewed and monitored to ensure that it “maintains a reasonable level of correlation... to the risks the purchase or sale is intended to hedge or otherwise mitigate.”³³ A further requirement on such continuing review and monitoring is that it “mitigates any significant exposure arising out of the hedge after inception.”³⁴ These provisions are clearly intended to prevent banks from seeking to make proprietary trading profits via embedded convexity in options and related contracts, a practice that is ubiquitous in the derivatives world, and which often takes place under the title of “dynamic hedging.”³⁵

As drafted, the Proposed Rule clearly shows an intent to prohibit this sort of activity consistent with the statutory mandate. However, the language must be tightened to make this explicit. For instance, §.5(b)(2)(iv) could include a direct reference to embedded convexity along with a stipulation that any such newly created risk must be **fully** hedged at inception.

(2) Those who approve hedges must attest that they meet the requirements of the Proposed Rule

Because the exemption for risk-mitigating hedging creates a potential avenue to evade the prohibition on proprietary trading, and because the rewards to covert trading could be large, the rules must reduce the incentives for evasion. In addition to making the changes proposed above, this can be done by requiring that supervisors who approve hedges affirmatively certify that the hedge conforms to the requirements of the rule, and have not been put in place for the direct or indirect purpose or effect of generating prohibited proprietary trading speculative profits. Although such a certification would come into play only if regulators were looking at specific transactions, it would nonetheless diminish the ex ante incentive to violate the law and the rules meant to enforce the law.

³¹ Release at 68948

³² Ibid.

³³ Ibid.

³⁴ Ibid.

³⁵ Taleb, N., "Dynamic Hedging: Managing Vanilla and Exotic Options," Wiley Finance, 1997.

E. Conflicts of interest must be addressed more effectively

The banking industry is no stranger to conflicts of interest. In a previous letter to the CFTC on issues related to conflicts of interest, Better Markets made the following observation³⁶:

“If the rules addressing conflicts of interest are not sufficiently restrictive or do not effectively limit the many indirect methods of exerting influence, a marketplace characterized by anti-competitive practices will continue. The transparent, competitive, fair and risk-reducing marketplace required by the Dodd-Frank Act will not be realized. Worse yet, risk-taking will actually be encouraged as the few participants that benefit from these arrangements maximize profits in markets structured to favor them.”

Given this backdrop, the prohibition of otherwise permitted activities in instances where they involve or give rise to material conflicts of interest is of critical importance to the success of the Volcker Rule.

The Proposed Rule attempts to implement the Dodd-Frank requirement that no banking entity may engage in a permitted activity if it would result in a material conflict of interest.³⁷ However, the approach in the Proposed Rule is at odds with the statutory requirements. The statute states:

(2) LIMITATION ON PERMITTED ACTIVITIES.—

“(A) IN GENERAL.—No transaction, class of transactions, or activity may be deemed a permitted activity under paragraph (1) if the transaction, class of transactions, or activity—

“(i) would involve or result in a material conflict of interest (as such term shall be defined by rule as provided in subsection (b)(2)) between the banking entity and its clients, customers, or counterparties;³⁸

Under the Proposed Rule, this statutory prohibition is not enforced. In impermissible contrast, banks would be permitted to mitigate conflicts of interest by either timely disclosure or a demonstration that informational barriers are in place which renders such conflicts irrelevant.³⁹ This is simply not what is countenanced in the statute, which clearly states that “no transaction class of transactions, or activity may be deemed a permitted activity” if it “would involve or result in a material conflict of interest.”⁴⁰

³⁶ Better Markets, Inc. Comment Letter Dated November 17, 2010 regarding Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest, available at <http://www.bettermarkets.com/sites/default/files/CFTC-%20Comment%20Letter-%20Conflicts%20of%20Interest%20SEFs%20DCOs%20%2011-17-10.pdf> and incorporated herein as if fully set forth here.

³⁷ Dodd-Frank Act §619 B(2)(A)(i)

³⁸ Subsection (b)(2) refers to the requirement for the Federal banking agencies, SEC and CFTC, to consult and coordinate to ensure harmony between their separate regulations.

³⁹ Proposed Rule, §__8(b)(1)

⁴⁰ Dodd-Frank Act §619 B(2)(A)(i)

A disclosed material conflict of interest is still a material conflict of interest. Therefore, under the statute, any transaction, class of transactions, or activity that gives rise to such a conflict is impermissible, disclosure or none.

Disclosure, therefore, no matter how thorough, must not be permitted to eliminate or mitigate the legal responsibility under the Proposed Rule. Nothing in the language or intent of Section 619 supports the creation of a broad exception from the prohibition against conflicts of interest based on disclosure.

In addition to violating the statutory mandate, disclosure is also a flawed remedy for conflicts of interest because it is exceedingly difficult to ensure that investors receive accurate, clear, comprehensible, and timely disclosure of the information they would truly need to understand the nature and significance of the conflicts of interest presented. In fact, a disclosure regime can actually facilitate abuse by enabling market participants to invoke the most obscure and meaningless disclosure to investors as a shield against liability.⁴¹

The Proposed Rule also allows banks to meet the limitation on conflicts by establishing “information barriers” adequate to prevent conflicts of interest that will adversely affect clients in a material way. Although under the Proposed Rule a bank cannot rely on such information barriers if they know or should know that such conflicts exist in a specific transaction, this proposal represents at best the triumph of hope over experience. Historically information barriers have proven to be unreliable and difficult for regulators to enforce. This has certainly proved to be the case in with respect to insider trading.⁴² A report of the Senate Permanent Subcommittee on Investigations shows that when there are huge sums at stake, traders have strong incentives to overlook conflicts in favor of their incomes.⁴³

In short, allowing a disclosure regimen to perpetuate conflicts of interest would gut the Proposed Rule and defeat Congress’s core purpose in enacting Section 619.⁴⁴

⁴¹ Thus, even were it the case that the statute permitted conflicts of interest to be mitigated by disclosure, the disclosure requirements in the Proposed Rule would have to be considerably strengthened so as to require written acknowledgment of the disclosure from the client, customer or counterparty. Otherwise, it is all-too-foreseeable that banks would seek to push the limits of “reasonability” in their disclosures as far as possible, undermining the purpose of such a disclosure allowance, which is to ensure that counterparties are properly informed. Furthermore, requiring acknowledgment of the disclosure would reduce ambiguity prior to the trade, eliminating costly dispute resolution after the fact.

⁴² See Christopher M. Gorman, Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers? IX Ford. J. of Corp. & Fin. L. 475 (Chinese Walls, whether used conceptually to prevent insider trading or structurally to prevent conflicts of interest, are inefficient, largely ineffective and have more shortcomings than advantages). A recent SEC enforcement action exemplifies the point: <http://www.sec.gov/news/press/2011/2011-144.htm>.

⁴³ U.S. Permanent Subcommittee on Investigations (2011). Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, Majority and Minority Staff Report, 7-11, available at http://levin.senate.gov/imo/media/doc/supporting/2011/PSI_WallStreetCrisis_041311.pdf

⁴⁴ In a related vein, the Proposed Rule allows conflicts of interest to be mitigated by “information barriers” intended to permit affiliates of firms, or different units within a firm, to engage in transactions that would otherwise be prohibited under the Proposed Rule. Apart from the fact that Section 619 does not contemplate such exceptions, information barriers are not reliable and are difficult for regulators to monitor and enforce. They have no place in the implementation of Section 619.

F. Responses to criticism of the rule by banks and foreign governments

This section addresses two criticisms of the Volcker Rule that have recently received significant attention. We show that those criticisms lack substance.

(1) The Volcker Rule will not reduce the supply of market making

Large banks have generated enormous profits by proprietary trading, which has generated untold billions in bonuses for their executives. Thus, those large banks, their executives, and their allies are strenuously opposed to the implementation of the Volcker Rule. Therefore they have looked for reasons, unrelated to its effects on their own incomes, to get the rule rejected or changed to the point of meaninglessness.

One of their more vigorously promoted claims is that a ban on bank proprietary trading will reduce the supply of market making services. The associated reduction in market liquidity is predicted to raise the cost of trading. This is a bad thing, according to this narrative, because it will make capital allocation more expensive and thereby reduce economic efficiency. These arguments are central to two papers – one produced by Oliver Wyman consultants, and the other by the academic Darrell Duffie – that were both sponsored by SIFMA.⁴⁵

However, examination of these arguments shows that they are based on dubious economic reasoning and are contradicted by independent academic research which has not been sponsored by the banking industry.

(a) The efficient supply of market making services is not dependent on the willingness of the few big banks subject to the Volcker Rule to provide it.

The supply of market making, like any other service provided in a capitalist economy, is determined by the returns that can be earned by providing it. When other parties are willing to pay enough for the service, suppliers will raise the necessary capital to provide it. When returns are high, the entry of suppliers will drive the price of the service toward minimum long run average cost.

If we accept the logic of market competition, there is no reason to believe that even a ban on **all** bank trading – which would go far beyond the restrictions of Section 619 – would have an important effect on the supply of market making services. So long as there is unfulfilled effective demand for market making services, entrants should be able to obtain all the capital they need to supply it and earn a competitive return.

Hence, if market making services currently supported by bank proprietary traders is eliminated at banks, it will be supplied elsewhere. Otherwise existing suppliers of market making services will earn above the competitive rate of return.

⁴⁵ D. Duffie (2012) Market Making Under the Proposed Volcker Rule, January; Oliver Wyman (2011). The Volcker Rule restrictions on proprietary trading – Implications for the US corporate bond market, December, available at <http://financialservices.house.gov/UploadedFiles/HHRG-112-BA-WState-SIFMA-20120118.pdf>

It might be (and has been) claimed that large bank holding companies who engage in proprietary trading have advantages of scale or scope – aside from reduced funding costs that arise from their “too big to fail” status – that translates into lower cost of market making and is reflected in the prices they charge for their services. However, the empirical research on scale and scope does not support the idea that large banks have efficiency advantages. Studies on bank scale economies show no increasing returns to scale for banks with assets above \$100 billion.⁴⁶ Nor is there convincing evidence of economies of scope from including broker dealers and commercial banks within the same holding company.⁴⁷

Absent empirically-established significantly greater efficiency, bank provisions of lower cost market-making services would not support the location of market-making in banks. If bank costs are lower because of their “too big to fail” status or because access to insured deposits and Federal Reserve liquidity raises bank holding company profits, and if in fact they are reflecting their lower cost of funds in the price of market making services, then those prices will result in an inefficient supply of those services.

The Oliver Wyman paper simply evades these issues entirely by saying 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.”⁴⁸

Thus, having admittedly ignored basic economics in its “analysis,” the conclusions of the study itself can be safely ignored as well.

The Duffie paper recognizes that “[s]ome of the lost-market making capacity might be filled by existing non-bank firms...”⁴⁹ But it then relies on conjectural deficiencies of other market makers to dismiss this outcome, noting that “...it is premature at best to assume that non-bank market makers will have the regulatory supervision, access to liquidity, and capital and liquidity requirements that are as effective as those for regulated banks.”⁵⁰ There is no detailed explanation why market forces will not supply efficient levels of capital or liquidity at competitive prices, or why regulation of non-bank market makers under Section 113 of the Dodd-Frank Act will be less effective than regulation under the Bank Holding Company Act.

In sum, it is irrational and baseless to assume that the revenue and profits from market making will be insufficient to attract capital and competition to that activity. While this conclusion based on such inexplicable assumptions closely coincides with the studies’ sponsors’ self-interest,⁵¹ basing a rule enforcing a legal mandate on such claims would be indefensible.

⁴⁶ S. Johnson and J. Kwak (2010). *13 Bankers*, New York: Pantheon, 212-213.

⁴⁷ See T. Milbourn et al. (1999). Megamergers and Expanded Scope: Theories of Bank Size and Activity Diversity, *Journal of Banking and Finance*, Vol. 23, 195-214.

⁴⁸ Oliver Wyman, op. cit., 4 available at <http://financialservices.house.gov/UploadedFiles/HHRG-112-BA-WState-SIFMA-20120118.pdf>

⁴⁹ D. Duffie op. cit., 5.

⁵⁰ D. Duffie op. cit., 6.

⁵¹ Some of SIFMA’s major members include: Bank of America Merrill Lynch & Co., Inc., Barclays Capital Inc., BlackRock, Bloomberg Tradebook LLC, BNP Paribas Securities Corp., Cantor Fitzgerald & Co., Citigroup Global Markets Inc., Credit Suisse Securities, Inc., Daiwa Capital Markets America Inc., Deutsche Bank Securities Inc., Goldman, Sachs & Co., JPMorgan Asset Management, JPMorgan Securities LLC, Morgan

(b) There is empirical evidence that proprietary traders do not provide liquidity

Both the Oliver Wyden and Duffie papers assume that because proprietary traders do a great volume of trading, their activity increases market liquidity. This assumption, however, is not supported in either paper and is in fact contradicted by research that has not been sponsored by the financial industry.

For example, an empirical study of the Taiwan stock exchange concludes that “[w]e have shown that dealers do not provide liquidity to the market; instead, they trade on information.”⁵² The authors note that this effect is particularly prominent during times of stress. Their findings suggest that even if banks radically reduce their trading as a result of the Volcker Rule, liquidity will not necessarily suffer during good times, and the system as a whole will be far safer during bad times.

This view is reinforced by the work of Professor Thomas Philippon at New York University’s Stern School of Management. Philippon’s work shows that as trading volumes have increased, the cost of intermediation to the market has actually increased as well, rendering the overall system **less** efficient.⁵³ Again, the analysis is clear: strongly restricting banks’ trading activities will make the markets more efficient, as well as safer.

If anything, the evidence suggests that the Rule should err on the side of being **too** restrictive, rather than too lenient as is the approach in the Proposed Rule.

(c) The alleged costs of reduced liquidity are never balanced against the cost imposed on the economy by high risk proprietary trading strategies

While the Oliver Wyman and Duffie papers allege, without proof, that the cost of the Volcker Rule will be very large, they ignore the gains of eliminating high-leverage maturity-mismatch trading in banks. In fact, events of the crisis show that those gains would be substantial.

As discussed in the Introduction and in Section C above, bank trading was a locus of bank losses and of shocks to the financial system. Billions of dollars in bank capital was destroyed, confidence in the financial system was shaken, and stability-threatening runs in the repo lending market were stemmed only by the provision of massive Federal aid. These developments were central elements of the financial crisis, which ultimately led to a downturn in the real economy that is second in severity only to the Great Depression of the 1930’s.

Stanley & Co. LLC, Mizuho Securities USA Inc., RBS Securities Inc., U.S. Bancorp Investments, Inc., UBS Securities LLC. Available at <http://www.sifma.org/about/memberdirectory.aspx>

⁵² J. Chae and A. Wang, “Who Makes Markets? Do Dealers Provide or Take Liquidity?,” August 2003 p30 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364635

⁵³ T. Philippon, “Has the U.S. Finance Industry Become Less Efficient,” November 2011 p22 available at (SSRN-id1972808[1]).pdf

Trillions of dollars of GDP have been lost, human capital has been destroyed by prolonged mass unemployment, and future policy flexibility has been destroyed by recession-created government deficits. Balanced against entirely speculative costs that would arise from eliminating proprietary trading in banks, there is no question that the trading restrictions in Section 619 provide a large net economic benefit.

(2) Foreign sovereign debt should not be exempt from the Volcker Rule, like U.S. Treasuries

Representatives of several foreign governments have asserted without any supporting argument or evidence that if large bank holding companies are not permitted to trade non-U.S. government debt, then those markets will be less liquid and more volatile than currently. For the reasons given in (1) above, there is good reason to reject these assertions.

Moreover, as the discussion of MF Global (see Section C. 2 above) shows, trading in foreign sovereign debt can produce huge losses to the trader. It is not clear why the U.S. should increase risks to its financial system, its treasury, and its taxpayers merely to accommodate the wishes of foreign governments regarding speculative claims of marginal liquidity in trading their sovereign debt. At a minimum, any foreign government requesting that a loophole be created in the Volcker Rule for them should be required to irrevocably commit to pay any and all direct and indirect future losses suffered by the U.S. financial system arising from, related to, or caused by any exempted trading in its debt.

G. No cost benefit analysis is required or appropriate because the law prohibits proprietary trading and any such analysis would show that the benefits would far exceed any costs

Because the law imposes a ban on proprietary trading by the few biggest banks in the country subject to the Volcker Rule, no additional cost-benefit analysis is necessary or appropriate. The Legislative and Executive Branches already made whatever cost-benefit analysis was appropriate and determined that a ban was necessary to protect the American people from another financial crisis.

However, to the extent a cost-benefit analysis is advocated or considered for **any** purpose, it must include the likely costs of a financial crisis materializing in the future and the benefits of avoiding such a crisis.

While the costs of a future crisis cannot be known with precision, the direct and indirect costs of the financial crisis that began in 2007 are known to a significant extent, and all such costs must be considered in any cost-benefit analysis.

In addition, the economic history of the United States demonstrates that the economic costs of this crisis, while extraordinarily high, could easily have been larger. Although the massive and unprecedented intervention by governments succeeded in preventing the financial crisis of September 2008 from spiraling into a Second Great Depression, that was not inevitable and not known at the time. Any meaningful cost-benefit analysis **must** explicitly take account of such possibility.

(1) Costs of the recent financial crisis must be considered in any cost benefit analysis of the Dodd-Frank rules

As a result of the financial crisis, trillions of dollars of GDP have been lost, human capital has been destroyed by prolonged mass unemployment, and future policy flexibility has been destroyed by recession-created government deficits.

These costs, of course, also cascade into other costs: delayed retirements, the millions of Americans on food stamps, declining mobility in the U.S. (due to job and housing lock), increased Medicaid recipients, decreased use of health care, tens of millions of people owning homes worth significantly less than they paid for them, entire neighborhoods and communities hollowed out by foreclosures and developer abandonment, the dramatic drop in tax receipts causing all sorts of services to be cut from firefighters, police, teachers, home health aides, elderly transportation, etc., and the list of costs goes on and on.⁵⁵

Also, moving interest rates to near zero and keeping them there for an extended period of time has provided money at virtually no cost to dealer banks, which can then lend or invest that money at higher rates. However, historically low to zero interest rates are also what every saver and most retired people in America have been receiving since September 2008. In addition to delayed retirements and other consequences, that policy has resulted in a massive subsidy of financial institutions.

Avoiding all those **costs** must be included when evaluating the *benefits* of a regulation like the Volcker Rule because those are the costs of a financial crisis the rule was designed and intended to eliminate or reduce.

(2) Cost of avoiding a Second Great Depression must be considered

Any cost-benefit analysis of a regulation arising from or related to the Dodd-Frank Act must consider the possibility of an actual Second Great Depression occurring next time. There is no guarantee one will be avoided and, therefore, the risk that another Great Depression will occur next time must be calculated into any cost-benefit analysis.⁵⁶ As we know, wishing away tail risk is a fool's errand. Such risks materialize more frequently than assumed and their outsized consequences and devastating impact have to be considered.

Recall, in the days after the failure of Lehman Brothers, the financial system essentially shut down. The short-term funding market (essential not only for Wall Street and financial institutions, but also for everything from the payroll of America's largest corporations to the smallest Main Street business) stopped functioning altogether. That freeze spread like a deadly frost throughout the national and, then, the international

⁵⁵ See, e.g., Better Markets, Inc., Costs of the Crisis, accessible at <http://bettermarkets.com/cost-crisis>. See also Federal Reserve Board of New York domestic Financial Crisis Turmoil Timeline and the International Timeline, accessible at http://www.newyorkfed.org/research/global_economy/policyresponses.html.

⁵⁶ Indeed, the cost of preventing the last financial crisis from becoming a Second Great Depression has actually increased the likelihood that the next financial crisis will result in a Second Great Depression. The costs of the last crisis required enormous fiscal spending, which saddled many countries with enormous deficits and debt, some unsustainable. That will greatly limit any fiscal response next time. In addition, the lack of accountability and transparency combined with apparent favoritism in some of the bailouts last time has eroded public confidence and will make future crisis responses much more difficult. Lastly, those same concerns about accountability, transparency and favoritism resulted in the elimination of some policy tools that were critical to stopping the contagion last time, i.e., the changes to the Federal Reserve's 13(3) authority.

finance system. As is well known, the finance system is the circulatory system that keeps the economy functioning. Without the finance system working, the U.S. and world economies would stop functioning as well.

It was only a matter of days after the collapse of Lehman that an economic calamity on the scale of the Great Depression, or worse, would likely have materialized. That risk and any costs connected to it have to be included in any cost-benefit analysis.

CONCLUSION

We hope these comments are helpful.

Sincerely,



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APPENDIX I

Table 1

Borrowing from PDCF

Dealer	Number of Borrowings	Average Amount Borrowed (\$M)	Total Amount Borrowed (\$M)
Merrill Lynch Government Securities Inc.	226	9,210	2,081,388
Citigroup Global Markets Inc.	279	7,241	2,020,219
Morgan Stanley & Co. Incorporated	212	9,022	1,912,625
Bear, Stearns & Co., Inc.	69	13,915	960,102
Banc of America Securities LLC	118	5,414	638,856
Goldman, Sachs & Co.	85	6,933	589,308
Barclays Capital Inc.	74	5,546	410,437
Lehman Brothers Inc.	10	8,332	83,322
Countrywide Securities Corporation	75	1,027	77,035
BNP Paribas Securities Corp.	43	1,544	66,375
Mizuho Securities USA Inc.	108	392	42,312
UBS Securities LLC.	8	4,425	35,400
Cantor Fitzgerald & Co.	61	460	28,060
J. P. Morgan Securities Inc.	3	1,007	3,020
Credit Suisse Securities (USA) LLC	2	750	1,500
Deutsche Bank Securities Inc.	1	500	500
Daiwa Securities America Inc.	1	440	440
Dresdner Kleinwort Securities LLC	1	93	93

Source: http://www.federalreserve.gov/newsevents/reform_pdcf.htm. Dealers ranked by total amount borrowed.

Table 2

Borrowing from Term Securities Lending Facility

Dealer	Schedule 1		Schedule 2		Total Borrowings (\$M)
	Average Amount Borrowed (\$M)	Number of Borrowings	Average Amount Borrowed (\$M)	Number of Borrowings	
Citigroup Global Markets Inc.	2,086	20	3,781	43	204,282
RBS Securities Inc.	1,610	14	3,298	43	164,370
Credit Suisse Securities (USA) LLC	1,592	11	2,966	41	139,094
Deutsche Bank Securities Inc.	2,746	20	2,546	31	133,866
Barclays Capital Inc.	1,733	21	1,700	43	109,508
Goldman, Sachs & Co.	1,221	15	2,445	36	106,328
Merrill Lynch Government Securities Inc.	610	5	2,298	33	78,891
Morgan Stanley & Co. Incorporated	517	6	1,224	25	33,706
UBS Securities LLC.	438	4	1,631	17	29,477
Lehman Brothers Inc.	395	5	1,276	13	18,560
Banc of America Securities LLC	838	8	820	14	18,177
J.P. Morgan Securities LLC	575	7	580	14	12,144
BNP Paribas Securities Corp.	718	9	99	10	7,458
Countrywide Securities Corporation	97	5	60	5	782
HSBC Securities (USA) Inc.	0	0	52	11	569
Cantor Fitzgerald & Co.	61	4	10	5	294
Bear, Stearns & Co., Inc.	0	0	35	2	69
Dresdner Kleinwort Securities LLC	33	2	0	0	65

Notes: The tables reports the average amount borrowed and the number of borrowings by dealer for the 33 Schedule 1 and 58 Schedule 2 operations. Borrowings through the TSLF Options Program are excluded. Dealers that never borrowed from the program are excluded.

Source: Archaya et al. (2011). Dealers ranked by total borrowing.