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Re: **Restrictions on Proprietary Trading and Certain Interests in,  
and Relationships with, Hedge Funds and Private Equity  
Funds (RIN 3038-AD05)**

Ladies and Gentlemen:

I would like to share some thoughts with you regarding the proposed implementation of the Volcker Rule. As a professional economist, this is an issue that deeply concerns me. For more than thirty years, I have been actively involved in the financial markets and economic policy debates. I am currently on the faculty at Yale University, and, prior to that, I served for 30 years in various senior capacities at Morgan Stanley, with the bulk of that time spent as the firm's chief economist. I have always cared deeply about critical policy issues that bear on the strength of the U.S. economy. This has been especially true in the aftermath of the financial crisis and in the discussions surrounding the Dodd-Frank legislation, of which the Volcker Rule is a critical piece. I have been following the debate over how to best implement the Volcker Rule, and believe that now is the right time to add my thoughts to these important discussions.

I am very supportive of the overall goals of the Volcker Rule, and I believe that the statute as passed by Congress could play an important role in ensuring the strength and integrity of the U.S. economy and our financial system. At the same time, I must confess to being concerned about the implications for the economy if the Volcker Rule were to be implemented under the initial draft of the implementing regulations. In recent weeks, senior officials, including Federal Reserve Chairman Ben Bernanke, SEC Chairman Mary Schapiro, and Representative Barney Frank have all remarked on the complexity of the issues involved in implementing the Volcker Rule and indicated a need to re-examine the agencies' initial plans for putting this proposed regulation into practice. I share their concerns – as well as the concerns expressed by many foreign governments, pension funds, asset managers, corporations, banks, and academics – that the currently stipulated rules would not only have unintended negative consequences for the U.S. and global economies but that they would also be unnecessarily complex and difficult to implement.

My main objective in submitting this comment is to make certain the Volcker Rule does what it is intended to do in ensuring financial stability without

jeopardizing the orderly functioning of financial markets. In my view, it is both critically important and possible to accomplish these goals, while also permitting banks to continue client-facing market making and hedging activities that are vital to the strength of our financial markets and the soundness of our banks. I believe this can be accomplished through an implementation of the Volcker Rule that is simpler than the proposed rules. In what follows, I outline a simpler approach to identifying and ensuring Volcker Rule compliance for both of these two key permitted proprietary trading activities – market making and hedging.

### Market Making

Market making is critical to the liquidity of global financial markets. To limit the effect of the Volcker Rule on banks' ability to conduct permitted market making, the agencies could replace the proposed market making criteria with an alternative framework that would center on whether the trading unit that conducts the purchase or sale, as well as whether the traders that plan and execute the purchase or sale, are focused on conducting or supporting client-related activities.

The central feature of this alternative framework would be the requirement that the trading unit, which principally conducts client-related activities, would need to be identified by several characteristics of client-related activities. In my experience, a trading unit engaged in permitted market making can be distinguished from one that is engaged in trading activities that are not client-related and therefore not be permitted under the statute if the trading unit has several of the following features: (1) utilizes a sales team to cover customers; (2) creates and disseminates research and investment content to customers; (3) provides trade execution and other advice to customers; (4) focuses on accommodating customer demand; (5) provides liquidity to customers; and (6) holds itself out as willing to buy or sell financial positions.

In addition, the trading unit conducting market making activities should be required to have an employee training program and written policies and procedures that are designed to promote the fair treatment of customers, as well as to manage conflicts of interest in accordance with such a fair-treatment standard. Also, all market making and hedging positions should be required to fall under the bank's board-approved risk management policies.

Finally, the agencies could integrate into the market making section the limitations suggested in the draft regulations that prohibit the following trading activities: those involving high risk assets or trading strategies, those which result in a material conflict of interest, or those which threaten the safety and soundness of the bank or the U.S. financial system.

## Hedging

Hedging is essential to permit banks to effectively manage their risks and enhance safety and soundness of the financial system. In order to continue effective hedging by banks, the hedging criteria in the draft regulations could be replaced with an alternative, less complex framework. An activity would qualify as permitted hedging if it involves taking an individual or portfolio position that: (1) is designed to mitigate current or expected individual or aggregated risks; and (2) is subject to continuing review and monitoring to ensure that it remains compatible with the board-approved risk management policies of the bank. Also, consistent with the statute and the draft regulations, I would suggest incorporating into the hedging criteria the requirement the activity must not result in a material conflict of interest with customers, nor create an exposure to a high risk asset or trading strategy, nor pose a threat to the safety and soundness of the bank or to the U.S. financial system. I believe this simplified hedging framework is sufficiently robust to prevent banks from conducting prohibited proprietary trading activities under the guise of hedging activities, while still allowing banks to do business in a safe and sound manner as originally contemplated by the Volcker Rule.

## Compliance Program and Monitoring

It is essential that each bank that conducts market making and hedging put in place a compliance program that produces comprehensive compliance records and metrics for review both by the Board of Directors of the bank and the responsible regulator(s). The current complex proposed language could be replaced with a simplified and effective framework. Each bank would be required to have a compliance program that includes: (1) written policies and procedures approved by the Board of Directors that are designed to document and monitor trading activities to ensure compliance with the Volcker Rule; (2) internal controls designed to monitor and identify any areas of potential noncompliance; (3) a management framework that clearly sets forth responsibility and accountability for compliance; (4) independent testing of the effectiveness of the compliance program; (5) training for trading and other personnel to effectively implement compliance; and, (6) recordkeeping sufficient to demonstrate compliance.

## Metrics

The agencies have thought very carefully about a number of mandatory compliance metrics. Many of these metrics will be critical to assuring compliance, but not all of the suggested metrics are relevant to all parts of diverse financial markets. Accordingly, the agencies could simply require that each trading unit that engages in market making produce the metrics suggested in the draft regulations related to market making on a quarterly basis, unless a particular metric is not relevant to a particular trading activity or unless it is not practicable to calculate it for that activity. Similarly, with respect to hedging, each trading

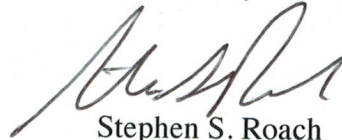
unit could be required to calculate on a quarterly basis the metrics suggested in the draft regulations related to hedging, unless it is not relevant or practicable.

The two-year proposed conformance period can be used as a trial run for the various metrics, after which the agencies could not only determine the proper calibration of these metrics, but also eliminate metrics that prove duplicative or less useful, or even decide that alternative metrics are more suitable.

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I want to thank the agencies for considering these comments. I hope that this suggested approach will assist the agencies in reducing the complexity of the proposed rules, while at the same time ensuring that the final rules faithfully implement the Volcker Rule.

Respectfully submitted,



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cc: Ben S. Bernanke, Chairman  
Board of Governors of the Federal Reserve

Mary L. Schapiro, Chairman  
Securities and Exchange Commission

Martin J. Gruenberg, Acting Chairman  
Federal Deposit Insurance Corporation

John G. Walsh, Acting Comptroller  
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