ICFR | International Centre for Financial Regulation

Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC
20429

13 February 2012

Re: **Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds.**

Dear Sirs,

Thank you for the opportunity to respond to your notice of proposed rulemaking, Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds.

Throughout, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC), will be referred to as "the Agencies".

The International Centre for Financial Regulation (ICFR) aims to provide a fresh perspective on the challenges of regulating global markets. As a non-partisan organisation, with the support of both industry and government, we act as a catalyst for dialogue, thought leadership and scholarship in this critical area. We also support practical training initiatives to improve understanding among practitioners and regulators. Our job is to encourage dialogue that identifies best practice across the traditional financial centres in the Americas, Europe and Asia and embraces emerging and developing economies worldwide. To this end, when the ICFR has relevant expertise or evidence of best practice that can be relevant, it submits comments on rulemaking.[1]

We will limit our answer to those areas in which we have the expertise to offer substantive comment. Our comments are split into two sections, the first comprising general remarks about the direction of the proposal, and the second looking at specific issues and questions.

§1 – General Comments

The ICFR wholly supports the ultimate aim of removing the principal-agent problem of proprietary trading. Efforts to date to use firewalls and grey lists to separate client information and flows from reaching those taking positions within the same institutions have not been entirely successful. However, the size and complexity of financial institutions, together with technology which permits, and regulations which require, the aggregation of information, make it increasingly difficult to ensure that information remains in specific

[1] For more on our organisation, please see www.icffr.org

silos in the institution. Moreover, as we will explain in more detail below, there is an enormous grey area between clear proprietary trading and clear agency business.

However, rather than going back pre-Glass-Steagall to the Pecora hearings and trying to genuinely split institutions that handle transactions on an agency basis from institutions that trade solely for their own account, the proposals have opted for a far more convoluted solution that leads us to ask: what precisely is it that this rule seeking to stop? A clear and concise response is not apparent from either the text of the Dodd-Frank Act, or the Agencies' proposals. As such, we do not believe the proposed rule, as structured, to be a practicable or sustainable piece of regulation which takes sufficient consideration of the long-term need to put financial markets on a clearer and more stable footing.

Neither the principle of proprietary trading nor the principle of risk-taking in the name of profit is inherently flawed. Rather, legislators and regulators are grappling with an historical problem; proprietary trading in high risk instruments was undertaken by institutions which did not bear the downside risks of their actions. In many cases, these institutions benefited from asymmetrical information at the expense of their clients and the wider community of investors, and ultimately the taxpayer. Disentangling the principles from the historical contingencies, which is essential in order to create sustainable new regulation, is difficult.

But the ICFR believes that the core principles here relate to conflicts of interest and the corporate governance of large financial institutions. Proprietary trading activity is often implicated in certain aspects of the financial crisis and in the failure of firms in the years subsequently (notably MF Global). But what is relevant here is not proprietary trading *per se*, but the growth of hugely risky, complex, opaque, institutions littered with misaligned incentives.

An attempt to prevent the sorts of activities which led to the financial crisis might plausibly rest on initiatives to mitigate conflicts of interest, rationalise business lines to improve resolvability, increase disclosure, improve internal risk oversight processes, improve corporate governance structures, increase capital requirements for risky instruments, mandate maximum leverage thresholds and minimum liquidity requirements, set position limits for certain instruments, and improve systemic oversight through macro-prudential regulation and supervision. Indeed, many programmes exist through which these issues are being addressed, both domestically and internationally. A partial catalogue of these initiatives include: the Basel Committee on Banking Supervision (BCBS) has revised its standards for capital; it has set out multiple liquidity regimes in the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR); it has introduced a leverage limit; it has revised Pillar II of the regime to improve risk management and related governance issues; and it has strengthened Pillar III disclosure requirements. Through the Office of Financial Research (OFR), US authorities will have the capacity to collect data on positions and counterparties, which the Financial Stability Oversight Council (FSOC) will be able to monitor as part of its ongoing macro-prudential supervision, with a suitably system-wide perspective. Macro-prudential regulation is evolving quickly, with central banks, national regulators, and transnational institutions developing new tools and perspectives. The FSB has recently created an expert group of international regulators to continue work on an internationally standardised Legal Entity Identifier (LEI), in addition to existing work done by US and other authorities, in order to make counterparty identification clearer and more consistent. This is to say nothing of work done on resolution regimes by a whole host of international and domestic agencies, which seek to make the structure of financial firms more clear and amenable to monitoring. These are but a few of the

multiple initiatives which are aimed at resolving deficiencies in the regulatory architecture and the financial system beyond regulation.

How and where does the current proposal sit in amongst this raft of international and domestic work? To take just one example, consider the new liquidity rules contained in Basel III. These international rules require banks to hold sufficient liquidity to manage a thirty day period of stress, as well as to have a stable source of funding over a 12 month period. How will the ban on proprietary trading in non-US government securities affect banks' abilities to meet these requirements in the long term? Moreover, the impact of the Volcker rule on the future of a liquid, efficient market for securities in the United States needs also to be considered. There is little indication that such issues have been considered.

Paul Volcker framed his intentions for the rule in simple terms:

> "If you are going to be a commercial bank, with all the protections that implies, you shouldn't be doing this stuff. If you are doing this stuff, you shouldn't be a commercial bank."[2]

This gets at the essence of the motivation for the Volcker rule as a way to limit the moral hazard of allowing institutions which benefit from deposit insurance to engage in proprietary trading. Whether or not the current proposal reduces this moral hazard or not, what is clear is that the proposal does not manage to do anything which can be summed up in two sentences.

When the UK authorities were hearing testimony from experts about reforming the banking system, Professor Charles Goodhart commented:

> "One of the considerations that you have to have is actually what you want your banking system to do. [...]How safe and how small do you want the banking system to be? If you make your banking system safer and smaller, what happens to the financing of your companies? You are going to push all the financial intermediation probably back on to the market. Will that make the world safer or will it make it more dangerous?"[3]

In its report, the UK Treasury noted further:

> "Policy makers, nationally and internationally, will need to decide on their priorities for the banking system. A lasting framework will only come about once these decisions have been made."[4]

Unfortunately legislation and policy have been made before a thoughtful consideration of these issues. As the global economy has entered a further period of significant difficulty and uncertainty, with policymakers reviewing their attitudes towards growth and stability, it is increasingly important that policymakers and regulators work to achieve consensus and clarity over what they want from the financial system in general, as well as from individual sectors such as banking more specifically.

---

[2] Interview with *The New Yorker*, 26 July 2012, available online at http://www.newyorker.com/reporting/2010/07/26/100726fa_fact_cassidy

[3] Available online at http://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/261/26105.htm

[4] Ibid

The lack of clarity in the aims of the rule is made worse by the level of complexity which is the inevitable result of trying to craft a rule which contains a large number of exemptions. This is compounded by the fact that the rule tries to distinguish market making from proprietary trading on the basis of the intention of a trade by using quantitative metrics and historical comparisons. The sheer level of work involved in such a process in terms of even constructing adequate data gathering and monitoring techniques, let alone in interpreting the information correctly and consistently, will be extensive. The fact that the rule requires banks to develop a whole compliance programme for this single rule speaks volumes.

However, regulators, like the regulated, must choose a risk appetite, and recognize that the regulations imposed will have a cost not only on the institution, but also on its clients, and the wider economy in terms of growth and tax revenues. “Proportionality” is critical. This is a lesson which is currently being re-learned. It is also one of the main forces behind the re-regulatory drive, where the perception is that activities which have such socially detrimental consequences must be regulated more strictly, with broader economic objectives increasingly being taken into account as we move away from the crisis.

We do not believe the proposed rule, as structured, represents a practicable, sustainable piece of regulation. The clarity which regulations need is removed by the difficulties of framing manageable exemptions, as well as the complexity of coordination among five organisations. We adopt this view not because we sympathise with the firms who will have to comply, but because the lack of clarity and serious scope for unforeseen consequences make the rule, and the activities it is intended to govern, opaque.

The ICFR is concerned that the division of responsibilities for monitoring the implementation of the rule among the agencies is not clear and could lead to regulatory ‘underlap,’ whereby certain aspects of the rule fall between agencies, with no agency claiming responsibility for the whole. We are concerned about the potential for inconsistent application or enforcement of the Volcker rule as likely to lead to such underlap given the difficulties of coordinating multiple agencies across multiple institutions. Added to testimony by regulatory officials to Congress in January 2012 that some agencies do not have the staff nor the skill-sets necessary to implement and enforce this rule as present, such issues must be addressed before this provision gains the force of law.

The Volcker rule is often compared to the Glass-Steagall Act because of the way in which it seeks to prevent certain activity through structural measures. The realised temptation leading to the repeal of Glass-Steagall in the late 20th century was heightened by competitiveness issues raised by US banks who were unable to conduct as broad a range of activities as foreign competitors operating as universal banks. The text of the current proposal explicitly recognises that there will be competitiveness consequences for US banks, and this has been raised by a number of officials elsewhere. International consistency in the regulation of global financial activity, within the context of the level of development of local economies and capital markets, should be paramount for stability reasons. The introduction of an entirely different banking structure in the US for internationally active banks and investment banks needs to be considered as a trade-off between the simultaneous goals of systemic stability and the need for strong international financial players to support American companies and interests abroad.

The Agencies are right to ask for specifics on the unintended consequences of many of the topics. However, rather than unintended consequences, the ICFR would focus on the consequences of complexity. It is not

simply that the consequences of certain aspects of the rule may be unintended, but that they are unpredictable on account of the intricacy of the rule. Such consequences are, by their very nature, more difficult to protect against and control. Complexity breeds unpredictability. Both regardless of, and because of, the myriad of agencies with oversight responsibility, it will be difficult to keep a holistic view of the consequences of the rule, operating as it does over multiple agencies, and requiring as it does such vast compliance material.

The ICFR believes that there is an inherent problem in trying to differentiate proprietary trading from market making. This is, of course, not lost on the Agencies, whose task it is to implement a rule which is faithful to the Dodd-Frank Act, already passed into law, which creates a dependence upon definitions and yet shies away from actually providing a number of those definitions. When deciding how to draft Section 619 of the Dodd-Frank Act, Congress faced a choice between two extremes, each with their own risks: banks could be allowed to engage in market-making while they enjoy the protections involved, or market-making could be forced entirely outside the banking sector, and hence out of the regulated sector. Instead, they opted for a middle path: banks would be allowed to be involved in market-making, to the extent that those activities "are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." The intention here was to prevent a complete withdrawal of important market making activity from the banking sector, while seeking to eliminate the aspects of that activity which could be used to disguise proprietary trading. But in practice, most market participants will tell you that this distinction is almost impossible to draw. Is an intra-day position against client orders to ensure a unit ends the day hedged market making or position taking?

The Dodd-Frank Act does not provide sufficiently well for the consequences of this trade-off. The Agencies have been left to fill in the rule and make operational a system which does not seem practicable either in a way which is consistent with the original intention of the statute, or in a way which is beneficial to financial stability. The six factors the Agencies outline as relevant for distinguishing permitted market making from prohibited proprietary trading seem broadly sensible in principle. But it is the practical workings of the proposals which are of concern, and not the logic of the reasoning involved. We will return to this point later. As noted by staff at the International Monetary Fund (IMF), the proposed system for identifying prohibited transactions "is more suited to an ex-post imposition of charges for non-compliance with the rule's requirements rather than as an ex-ante or concurrent identification device by supervisors. In other words, it is not designed to tell apart individual market making or hedging transactions from opportunistic proprietary trades."[5] The ICFR does not believe that this was the intention of the rule, and it does not seem to us to be a suitable second best.

Furthermore, there has not been a sufficient amount of attention paid to the short-term consequence that a large amount of market making activity will be prohibited from the middle of 2012, without other market participants in the financial system having the capacity to absorb this activity quickly and efficiently. In the long-term, it is likely that non-banks will step into the vacuum left by the proposed rule. However, the financial stability consequences in the immediate short-term will be negative. It is peculiar that one consequence of this rule is that policymakers and regulators must hope that *more* activity is undertaken by the under-regulated "shadow" banking sector in order to maintain sufficient liquidity in the markets.

[5] See Julian T.S. Chow and Jay Surti, 'Making Banks Safer: Can Volcker and Vickers Do It?', *IMF Working Paper WP/11/236*, available online at http://www.imf.org/external/pubs/ft/wp/2011/wp11236.pdf

Increasing the size of the "shadow" banking world is often cited as an undesirable unintended consequence of new rules, but it seems that the Volcker rule has been formulated with this precisely in mind. The ICFR would like to, once again, stress the unpredictability of this, especially in the context of a system where full-scale macro-prudential supervision is not yet operational.

Beyond these problems, and particularly pertinent from our perspective as an international organisation, are the extensive extraterritorial implications of the proposals. For non-US banks and financial firms the proposals are very consequential in terms of compliance. Even for those firms who are subject to exemptions there will be an enormous amount of work involved in terms of ensuring that they are not caught through their interactions with other market participants. For instance, in order to meet the exemption for foreign trading by ensuring that all proprietary trading activity takes place solely outside the United States, firms would appear to have to check every member of any fund acting as a counterparty to see whether those members were resident in the United States. Where will the burden fall here? To what extent will companies be responsible for ensuring compliance with such requirements, and to what extent will they be permitted to rely on the attestation of their counterparties? There seems to be the potential for non-US banks to become subject to the requirements of a US rule on account of reporting errors made by counterparties, which themselves may not even be located in the United States. We will discuss these issues in more detail in the next section.

In summary, the ICFR believes that the proposed rule is not fit for implementation. The sheer complexity of its implementation will entail unpredictable consequences which the Agencies are currently not in a position to monitor, for an end which is unclear.

§2 – Specific Issues

The foregoing criticism notwithstanding, the ICFR recognises that the Agencies must implement some form of the rule. As such, in this section we direct comments to some of the specifics of the proposal, including the exemption for market making, the exemption for trading in US government securities, the extraterritorial consequences of the rule, and the conflict of interest provisions.

Market Making

As mentioned above, the ICFR believes there is an inherent problem in trying to differentiate market making from proprietary trading. The proposal attempts to distinguish them with quantitative metrics and historical comparative analysis. The six factors the Agencies outline as relevant for distinguishing permitted market making from prohibited proprietary trading seem broadly sensible in principle. But as we have already remarked, it is the practical workings of the proposals which are of concern, and not the logic of the reasoning involved. Question 184 asks whether the six factors are helpful for making the distinction. We would suggest that they are.

However, once you dig further into the implementation of the proposals, it becomes clear that being helpful is not sufficient for ensuring that the aims of the rule are met. For instance, the Agencies indicate that assessing whether a trading unit's risks are being retained "in excess of amounts required to provide intermediation services to customers", the Agencies will look at Value at Risk (VaR) measurements, Stress

VaR, VaR Exceedance, and Risk Factor Sensitivities, among others. But if these measures are doing the job they are supposed to, and proprietary activity does not exceed the group's expressed risk appetite, is it necessary to have this further limit on risk taking, based on the Agencies' judgment of the level of risk necessary for *bona fide* market making? If it is deemed necessary, then this would seem to imply a distrust of the fitness of existing instruments for managing risks, whether they are macro- or micro-prudential.

Our overriding concern with the attempt to distinguish market making from proprietary trading is not that it would not capture proprietary trading activity, if it were possible to implement effectively. Rather, it is that necessarily, by seeking to capture such activity the rule will ensnare a huge amount of legitimate business. *Appendix B* attempts to set out guidance on the issue, including "explanatory facts and circumstances" which might explain a bank's activities. The Agencies recognise that there are certain circumstances in which market making activity may appear to be proprietary, including when there are general upward or downward price trends, or market-wide adjustments of risk perceptions, or unanticipated changes in the price of retained principal positions and risks, and so forth. The ICFR would argue that it is not the role of regulatory agencies to second guess whether changes in price or general market trends are anticipated or not. Such a set of proposals would seem to favour less insightful firms who hold positions which improve despite their ignorance, over firms with the skills and knowledge required to understand the market. We do not see that incentivising ignorance in this way improves the stability of financial markets.

As an example, suppose a firm engaged in *bona fide* market making was to come to the judgment that a significant market disruption was imminent – would they effectively be prevented from acting on that business decision, which they might argue was being taken on behalf of minimising the losses (or maximising the gains) for their clients? Hedging activity to prevent large losses might require the taking of positions which are considered proprietary because they breach historically normal VaR bounds – how will the Agencies distinguish these cases? The prevention of large losses relative to one's peers would seem to be every bit as proprietary as the gaining of profit, in this respect.

Trading in Government Securities

In recent weeks, a number of senior figures from a range of countries have expressed concerns about the exemption for trading in US government securities. The need for the US financial system to provide liquidity and market making in US government securities is evident. However, the explicit limitation to US government securities, given the size and depth of US markets, discriminates against other government securities in a way that is likely to encourage other governments to enact reciprocal prohibitions for their institutions. Given the need for foreign financing of US government, and current account deficits, this would have disastrous consequences. Moreover, there are no characteristics unique to US government securities, other than the need to finance the US government deficit, which justifies their inclusion or exclusion from proprietary trading. If the Volcker rule is to contain an exemption for trading in government securities, this should extend to all liquid, high quality government securities, irrespective of nationality. Banks provide important sources of liquidity to governments, as current world events, notably in the Euro zone, demonstrate.

Question 122 asks whether there should be an exemption for trading in the obligations of foreign governments and/or international and multinational development bank. We would argue that given the

presence of an exemption for US government securities, it is essential that the proposals contain an exemption for the securities of foreign governments and multilateral development banks.

A number of institutions, such as the Bank of Japan and the Bank of Canada, have publicly and formally expressed their unhappiness with the proposals, and there have been press reports of officials from the European Commission, the United Kingdom and other countries having expressed their concerns privately. The ICFR believes that these concerns are legitimate and have a basis in stability issues. As such, we urge the Agencies to cooperate with the regulators of the G20 to find a formula that permits trading in government securities across borders in due proportion to the relative depth, liquidity, and credit quality of those markets and securities[6].

Extraterritoriality

§__.6(d) of the proposed rule sets out the foreign trading exemption. §__.6(d)(1)(i) states that the exemption will operate if banking entity "is not directly or indirectly controlled" by a banking entity organised under US law. But the definition of control used in the rule, along with the fact that (a) US subsidiaries and branches of foreign banks do not qualify for the exemption, and (b) the fact that the rule states that some of the standards will apply to any bank which "*together with its affiliates and subsidiaries*," meets various criteria, means that a foreign firm which indirectly controls any branch in the United States will be subject to the reporting standards on its entire collective global operations. Further, the relevant agency would then "have access to all records related to the enterprise-wide compliance program pertaining to any banking entity that is supervised by the Agency vested with such rulewriting authority." The consequences of this would appear to be exceptionally far-reaching. Extraterritoriality of this kind creates unnecessary burdens for firms across the world, with potentially highly significant costs for firms which only incidentally come into contact with the US banking system.

Not only are the extraterritorial implications extensive for firms which will be subject to the proposed rule, but the implications for firms wishing to avoid the extraterritorial consequences of the rule will be similarly onerous. Any bank wishing to sever ties to the US banking system will quickly discover that this is very difficult; avoiding counterparties subject to the rule will be very difficult, given the extent of interconnections in international financial markets.

Question 138 asks whether the provisions for whether an activity is conducted solely outside the United States are clear. The ICFR believes that the implications of these aspects of the rule are at best exceptionally unclear, and at worst are such that they merit re-proposal.

With respect to non-US banks operating in the United States, the proposals state that a bank which, together with its affiliates and subsidiaries, on a worldwide consolidated basis, has trading assets and liabilities (subject to certain qualifications) equal or greater to $1 billion, will be required to comply with the reporting and record keeping requirements set out in Appendix A. Appendix A then details that any trading unit which engages in the execution of any covered trading activity will be required to keep quantitative records as set

[6] We note specifically that current Basel II rules encourage financial institutions to hold large concentrations of the highest yielding sovereign bonds without regard to credit quality or liquidity, and the urgent need to address this anomaly.

out in that Appendix. But "trading unit" is then defined to include "all trading operations, collectively; and any other unit of organisation specified by [Agency] with respect to a particular banking entity." This appears to go far beyond what might be considered reasonable in terms of reporting. It would not be appropriate for a non-US global bank to have to report on "all trading operations, collectively" when a majority of these may be conducted outside of the United States.

With respect to the foreign trading exemption as delineated in §__.6(d)(3), the overview of the proposed rule states that the following four criteria are "intended to ensure that a transaction executed in reliance on the exemption does not involve U.S. counterparties, U.S. trading personnel, U.S. execution facilities, or risks retained in the United States":

- The transaction is conducted by a banking entity that is not organized under the laws of the United States or of one or more States;
- No party to the transaction is a resident of the United States;
- No personnel of the banking entity that is directly involved in the transaction is physically located in the United States;
- The transaction is executed wholly outside the United States.

The ICFR is concerned that the framing of the exemption, along with the definitions of "resident of the United States", create undesirable extraterritorial implications. The exemption as framed goes far beyond that required to realise the intention of the statute. In particular, the guidance does not provide clarity as to when a transaction will be considered to have been "executed wholly outside the United States", and it is unclear that the relationship between trading and execution warrants the inclusion of this clause in the proposal.

Further, the requirement that no personnel of the banking entity that is directly involved in the transaction is physically located in the United States would seem to capture the activities of an entire trading team in the event that one member of that team who had, for instance, done preparatory work on a trade, was travelling in the United States at the time that a trade was executed. Some trades can take a considerable amount of time to put together before execution among teams of people which may change over that period of time. If the proposals are not amended to reflect this then there needs to be a far greater level of detail in the guidance as to how such clauses will be interpreted.

Conflicts of Interest

Section__.8(a)(1) forbids activities which would involve or result in a material conflict of interest between the covered banking entity and its clients, customers, or counterparties. Section__.8(b) defines "material conflict of interest", and paragraphs 8(b)(1)(i) and (ii) and 8(b)(2) outline exemptions for when there has been "timely and effective disclosure and opportunity to negate or substantially mitigate" the conflict of interest, or for where there are "reasonably designed" information barriers to prevent conflicts of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty.

The rule provides that "clear, timely, and effective disclosure" should provide "necessary information, in reasonable detail" such that a "reasonable client, customer, or counterparty" may "meaningfully understand

the conflict of interest." It is recognised in the overview of the rule that the difficulties here are elevated when transactions are "complex, highly structured or opaque, [involve] illiquid or hard-to-value instruments or assets, [require] the coordination of multiple internal groups [...] or [involve] a significant asymmetry of information or transactional data among participants." The ICFR would emphasise the importance of strict enforcement of standards for clear information provision adapted to both the product and the client. The ICFR understands from its stakeholders in a number of jurisdictions that there are problems with point-of-sale disclosure practices. It is difficult to strike the right balance between *caveat emptor* and the simple behavioural fact that customers tend not to read large numbers of pages of densely written disclosure information. However, we have found there to be widespread support for making such disclosures significantly simpler.

There are varying levels of complexity in financial markets. For financial stability reasons, it is important that complexity is understood. Ensuring that parties understand more complex transactions will require those parties to be held to higher than usual standards of governance, and will require more advanced systems and more capable staff. As such, we believe that the thresholds for requiring these higher standards to be in place should be relatively low.

The proposed rule would benefit from additional guidance as to what constitutes "reasonable detail". Without entering into the details of the US distinction between 'sophisticated' investors and 'unsophisticated' investors, it is clear that certain supposedly very sophisticated customers failed to understand the complexities of certain structured products in the financial crisis, and the entire process of product and conflict disclosure, as well as investor education and financial literacy continue to need significant thought, though this goes well beyond the remit of this consultation.

The potential conflicts of interest that arise from a bank which operates as a broker or provides investment advice to clients, but which also engages in proprietary trading, or has substantial interests in hedge funds which are involved in such trading, are plain. However, this does not mean that they are easily classifiable when potential instances are identified. To take one recent high-profile case – the SEC's case against Goldman Sachs concerning the ABACUS transaction – some have argued that aspects of the business of universal banks here fall into a "grey area".[7] Where banks, who may engage in proprietary activity, are acting as broker-dealers, to what extent should they be responsible for informing their clients of the particulars of a trade, and to what extent should clients be expected to engage in due diligence? To what extent are banks' own views of the likely future direction of the underlyings in a transaction relevant to the clients on each side? With certain trades, there will be 'winners' and 'losers', where the opposing sides of a deal have reached different conclusions about the prospects for a particular instrument or market. These conclusions may be ill-considered, or speculatively formed, but they may be the product of professional judgment about complex issues which are contestable and arguable from a number of angles. In the latter cases, the broker may well have its own view. Should brokers be under a regulatory obligation to disclose those views? We note that the question of whether brokers should have a fiduciary duty towards their clients remains open. Section 913 of the Dodd Frank Act requires a study into the obligations of brokers, dealers and investment advisers, with respect to retail customers, and the SEC's study published in January 2011 recommends that broker-dealers be given a fiduciary duty towards such investors when dealing with

[7] See, for instance, Alan Morrison, William Wilhelm and Rupert Younger's paper "Reputation in financial markets", in *Investing in Change: The Reform of Europe's Financial Markets*, AFME, 2011.

securities. It also notes that broker-dealers are generally required to make recommendations that are "consistent with the interests of its customer." But despite the fact that the widely publicised ABACUS case, which has substantially affected public perceptions of such practices, was a wholesale trade between "sophisticated" market players, there is no mention in section 913 of fiduciary duties towards non-retail investors. Further, according to the SEC's website, there has not even been a date set for the proposal of rules based on the recommendations of the section 913 study.

Section 913 states that the offering of proprietary products by broker-dealers will not be, of itself, considered contrary to any fiduciary duty which may be placed upon such broker-dealers, but will be subject to disclosure, as well as the notice and consent of customers. This is at the heart of the issue over the ABACUS transaction – what level of disclosure was it reasonable for Goldman Sachs' clients to expect, given that the firm was operating as a broker-dealer on the transaction? Was the firm under an obligation, legal, ethical, or otherwise, to provide explicit information regarding the Paulson hedge fund's short position, or the involvement of the Paulson fund in selecting the securities themselves? Since the current law does not put broker-dealers' obligations on the same level as investment advisers, this will remain a grey area, and the proposals under question do not appear to address the issue.

Question 200 asks whether written disclosure to a client, customer, or counterparty regarding a material conflict of interest should be required. It further asks whether there are circumstances in which oral disclosure would suffice, particularly in certain fast-moving markets with "sophisticated clients, customers, or counterparties?" The ICFR struggles to see how a requirement for written disclosure in all circumstances would be practicable given the pace of trading and position taking in financial markets. The possibility of oral disclosure is an interesting one, which perhaps merits more attention. However, there would be a number of outstanding issues surrounding the possibility of oral disclosure of conflicts of interest: would all oral disclosures have to follow the same format? Would they be scripted, for instance? What would constitute an agreement that an oral disclosure had been received and understood? Would such agreements have to be recorded, and if so, would investors have to keep detailed records of oral disclosures themselves? Would Agency staff be required to keep transcripts? In short, how would an oral disclosure regime be enforced in such rapidly evolving markets? Oral disclosure seems to carry benefits over written disclosure at first glance, but its implementation would clearly entail substantial difficulties, and would perhaps lead to increased opportunities for litigation.

Question 201 asks: "Should the proposed rule provide further detail regarding the types of conflicts of interest that cannot be addressed and mitigated through disclosure? [...] Should the proposed rule enumerate an exhaustive or non-exhaustive list of conflicts that cannot be addressed and mitigated through disclosure?" The ICFR believes that providing a list of such conflicts would be dangerously prescriptive, and may introduce further moral hazard problems into the process. Regarding conflicts of interest, it is surely more appropriate to encourage a culture in which conflicts of interest are seen as negative from a bank's perspective, and transparency is seen as a desirable part of trusting business relationships, rather than providing a list of circumstances in which a bank can rely on a compliance process for managing such conflicts.

Regulatory Learning

Good regulatory practice is to recognise and make explicit the fact that regulation will develop over time in response to practical experience. For instance, the Agencies' recognition that metrics for assessing whether underwriting, hedging, and market making are prohibited or not are not hard-and-fast, but are inputs into a process of learning, is mature and to be welcomed. Furthermore, there is always the possibility that a new proposal ends up tying the hands of a regulatory organisation by being too prescriptive and making the room for manoeuvre too narrow. The proposal does seem to manage this possibility well. The Agencies write:

> "The Agencies intend to take a heuristic approach to implementation in this area that recognises that quantitative measurements can only be usefully identified and employed after a process of substantial public comment, practical experience, and revision."

We commend this approach, but would add that a commitment to this approach comes with increased obligations for the Agencies involved, in terms of keeping the market aware of developments in thought and methods, and providing timely and transparent information and guidance about amendments to rules. As we wrote to the Financial Stability Oversight Council in December 2011, the capacity for discretion comes with an obligation for disclosure. In the name of transparency, the Agencies should set themselves a publicly available schedule for the learning process, as well as a set of criteria for assessing the success or failure of different approaches. This would help to engender a more collegiate approach to regulation in general. However, with respect to the current proposal, we fear that even with this mature approach, it will simply be infeasible for the Agencies to adequately exercise their judgment over such a vast array of activities, data, and consequences.

Conclusion

We should be clear that our concerns with the proposed rule are not simply concerns about compliance burdens or the costs of a new regulation. That a new regulation creates a burden or a cost for a regulated entity is not of itself a reason not to carry it through, and good regulation has the potential to improve financial markets. Our concerns are that fundamentally, the current formulation of the Volcker rule increases complexity, and thus the scope for regulatory arbitrage, rather than reducing it.

We would like to emphasize the importance of proportionality. In the first instance, the ICFR has concerns about the direction of the Volcker rule itself, as formulated in the Dodd-Frank Act. We recognise that this legislation has already been passed, and that it is not for the Agencies' to override the law. However, the difficulties to which we have pointed are symptomatic of the text of the Dodd-Frank Act itself. The aim of the law seems to be to force the restructuring of universal banks in order to remove public subsidies, which are the result of federal deposit insurance schemes, for excessive risk taking. This is the essence of Paul Volcker's remark, quoted in our general remarks above. But lawmakers have been persuaded that commercial banks should be able to perform certain activities which are not easily distinguishable from activities which may prove excessively risky, such as market making, hedging, and underwriting. This has meant that a relatively simple principle has been lost to the legal technicalities of framing exemptions and implementing a considerable compliance regime.

The financial crisis should have been a catalyst for better regulation. Unfortunately, the proposed rule appears to not to have learned the lessons of previous mistakes. In particular, they are out of proportion, are too complex, will have negative consequences for market making in the short term, are extraterritorial, are inconsistent with respect to certain exemptions such as government securities, and fail to place themselves within the broader context of the global market and existing international standards. The current proposals are an excessively complex and unsustainable set of rules, which will not be conducive to the long term stability or efficiency of financial markets. We hope that they will be reconsidered.

Yours faithfully,

Barbara Ridpath
Chief Executive

John Andrews
Research Analyst

For and on behalf of

International Centre for Financial Regulation