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November 5, 2010

Hon. Timothy F. Geithner
Chairman, Financial Stability Oversight Council
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds, 75 Fed. Reg. 61,758 (Docket No. FSOC-2010-0002)

Dear Chairman Geithner:

The Committee on Capital Markets Regulation* appreciates the opportunity to comment on the Financial Stability Oversight Council's request for public input regarding the study on the implementation of the restrictions on proprietary trading (the Volcker Rule) in § 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1]

Since 2005, the Committee on Capital Markets Regulation (Committee) has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled, The Global Financial Crisis: A Plan for Regulatory Reform (Report), which contains 57 recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.[2] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.[3]

* Not every member of the Committee is in favor of the approach taken by this letter.
[1] 75 Fed. Reg. 61,758 (Oct. 6, 2010); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619 [hereinafter Dodd-Frank Act]. All subsections of § 619 referenced in this letter are references to subsections of § 13 of the Bank Holding Company Act of 1956 as amended by § 619 of the Dodd-Frank Act.
[2] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), http://www.capmktsreg.org/research.html.
[3] *See* Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs and Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. (Mar. 4, 2010) (proposing a comprehensive approach to reducing systemic risk from over-the-counter derivatives); *see also* Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, and Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. (June 14, 2010).

As Hal S. Scott, Director of the Committee, explained in testimony before the Senate Committee on Banking, Housing, and Urban Affairs,[4] proprietary trading was not a source of systemic risk that precipitated the financial crisis of 2008, nor did it create significant inherent conflicts of interest between banks and their customers. Instead, it helped banks service the needs of their customers, diversify their businesses, and compete with foreign banks. Proprietary trading also had several substantial benefits for the financial markets, such as increasing liquidity, improving price discovery, and promoting market efficiency. The Committee urges the Council to recognize these benefits by narrowly implementing the ban on proprietary trading. The comments below provide specific guidance on several important foundational elements and exceptions to the rule.

Foundational Elements

1. **"Proprietary trading."**[5] This is the key definition that will influence the application of all of the implementing regulations. We propose that proprietary trading be defined narrowly by being limited to trading activities set up with segregated capital and separate teams of personnel that do not interact with customer businesses or rely on customer deposits. This approach will ensure it does not cover activities that are driven by or in response to customer needs, requests, or orders.

2. **"Selling in the near term."** Under the Dodd-Frank Act, a "trading account"[6] used for proprietary trading is defined to be used principally with the intent to "sell[] in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)." This implies that the motives of the banking entity when initially acquiring the security or instrument are highly relevant in determining whether impermissible proprietary trading is occurring. The phrase "near term," however, is also used in the exception allowing for market making "for the reasonably expected near term demands of clients."[7] The phrase need not be defined the same way in both places. Although there is an important temporal aspect in both uses, the regulators should take care not to define the term in such a way as to prohibit either long-term investments or market making.

3. **"Material conflict of interest,"**[8] **"material exposure,"**[9] **"high-risk assets,"**[10] **and "high-risk trading strategies."**[11] These terms are designed to enable rule makers to prohibit trading that would technically fall within a statutory exemption but otherwise is inconsistent with the asserted purposes of the Volcker Rule.[12] In defining these terms, they should set high thresholds,

[4] Prepared Written Testimony of Hal S. Scott before the S. Comm. on Banking, Hous. & Urban Affairs (Feb. 4, 2010). This testimony did not necessarily represent the views of the Committee.
[5] Dodd-Frank Act § 619(h)(4).
[6] *Id.* § 619(h)(6).
[7] *Id.* § 619(d)(1)(B).
[8] *Id.* § 619(d)(2)(A)(i).
[9] *Id.* § 619(d)(2)(A)(ii).
[10] *Id*.
[11] *Id*.
[12] This might include highly leveraged hedges (options, futures, or other derivatives) in an illiquid market where the bank has publicly been very bullish and doing a substantial flow business.

so that only activities harmful to customer interests and those that pose a systemic risk, the stated purposes behind § 619, are prohibited.[13]

Exceptions

Notwithstanding the general restriction on proprietary trading, § 619(d)(1) specifies a number of permitted activities and, through subsection (d)(1)(J), gives the agencies the authority to specify "[s]uch other [exceptions] as the appropriate…[agencies] determine, by rule,…would promote and protect the safety and soundness of the banking entity and the financial stability of the United States." We encourage them to narrow the effect of the rule by using this authority because a narrow ban will *increase* the safety and soundness of banks and the U.S. financial system.

1. **Transactions involving U.S. government or agency obligations.**[14] The first exception to the general ban on proprietary trading allows banking entities to trade obligations of the U.S. government, agencies, states, or political subdivisions.[15] Rule makers should broaden this exemption, under the authority in § 619(d)(1)(J) to create new permitted activities, to include trading in securities issued by foreign governments. A foreign branch of a U.S. bank and a U.S. branch of a foreign bank should both be permitted to trade in government debt issued by any government in any currency. Such activities are not inherently risky and in any event the risk will be supervised. This approach will ensure there is fairness and consistency in implementation of the new rules.

2. **Transactions in connection with underwriting or market-making-related activities "to the extent that any such activities…are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."**[16] This is an important carve-out in the Rule, as rule makers must define what types and level of trading activity in any one security are necessary to rise to the level of permissible customer order facilitation or market-making. Implementing this exception requires an understanding that it is not always possible to trace every trade back to an instruction from a specific client. Banking entities try to accommodate their clients' needs even if it requires buying something from a client that may not be able to be resold immediately. That service, of providing a price for an asset and taking risk away from a client, is a core function of a banking entity and should not be discouraged.

3. **"Risk-mitigating hedging activities."**[17] This is another important carve-out that requires banking entities to demonstrate their intent to reduce risk, rather than make a near-term profit, when acquiring a security.[18] Once again, this term should be defined in a way that ensures a banking entity has the broadest flexibility to manage and hedge risk with a broad array of financial instruments. In the event a dealer buys an asset from a client that cannot immediately be resold, it may hedge with something that approximates but does not exactly match the risk of the asset until it can find a buyer. This type of hedging activity, which enables a dealer to service

[13] *See* Dodd-Frank Act § 619(b)(1).
[14] *Id.* § 619(d)(1)(A).
[15] *Id*. It also includes investments in small business investment companies registered with the SEC.
[16] *Id.* § 619(d)(1)(B).
[17] *Id.* § 619(d)(1)(C).
[18] *Id*.

its clients, should be allowed. Also, hedges should be able to be justified on an individual position level or on a portfolio level, so long as they exist to reduce "specific risks"[19] of those risky "positions, contracts, or other holdings"[20] a banking entity deems it necessary and appropriate to hedge. Related to this, a hedge also need not be a short position, because long positions are often valuable for mitigating certain risks.

4. **Transactions "on behalf of customers."**[21] Although legislators narrowed this exception in the conference process, we believe it should be expanded by regulators under the rulemaking authority provided by § 619(d)(1)(J), discussed above, to include all transactions that facilitate customer relationships. The provision should permit any trade that is customer-initiated or based upon a banks' accommodation for a customer, even if the bank creates a bespoke security in response to anticipated customer needs. If banks are to continue providing valuable financial products and services to customers, then they must be able to have the broadest flexibility to accommodate and facilitate customer needs and demands. Moreover, if banks cannot provide these services then those activities may migrate to more lightly regulated institutions, an outcome the Council may want to avoid.

5. **"Investments in SBICs, public welfare investments, or investments in qualified rehabilitation or certified historic structure projects."**[22] Although these instruments are rarely traded by banks, rule makers should clarify that investments in them do not constitute proprietary trading, regardless of holding period, intent, or purpose. This is because of their illiquid and long-term nature, along with the fact that they support important governmental objectives.

6. **"Transactions by a regulated insurance company (and its affiliates) for its general account."**[23] This exemption, for banking entities that may have affiliated insurance entities, should be clarified to allow for all trading activities, so long as they comply with state insurance laws and are necessary to conduct the ordinary business of insurance.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

R. Glenn Hubbard	John L. Thornton	Hal S. Scott
Co-CHAIR	Co-CHAIR	DIRECTOR

[19] *Id.*
[20] *Id.*
[21] *Id.* § 619(d)(1)(D).
[22] *Id.* § 619(d)(1)(E).
[23] *Id.* § 619(d)(1)(F).