Testimony of Douglas Peebles, AllianceBernstein

Before a joint hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services

January 18, 2012

Good morning, Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the Committee:

My name is Douglas Peebles; I am the Chief Investment Officer and Head of Fixed Income at AllianceBernstein, a global asset management firm with approximately $424 billion in assets under management. AllianceBernstein is a major mutual fund and institutional money manager and our clients include, among others, state and local government pension funds, universities, 401(k) plans, and similar types of retirement funds and private funds. I appreciate the opportunity to testify before you today on the implications of the Volcker Rule on behalf of the Securities Industry and Financial Markets Association's[1] ("SIFMA") Asset Management Group ("AMG")[2] of

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered

which AllianceBernstein is a member. SIFMA's AMG represents approximately $20 trillion in combined assets under management and is the voice of the buy-side within the securities industry and broader financial markets.

On November 7, 2011, four out of the five Agencies tasked with promulgating regulations to implement the Volcker Rule released a proposal that seeks public comment on over 1,400 questions of increasing detail and complexity, with the fifth Agency releasing its proposal last week. Unfortunately, although Congress identified a number of permitted activities that are beneficial to the functioning of a stable financial system, the Agencies have exercised their discretion in a manner that exceeds their statutory authority and conflicts with congressional intent. The proposed regulations set forth overly prescriptive standards for each of the permitted activities, resulting in a presumption that these activities are prohibited unless they conform with a narrow set of requirements that do not reflect the actual functioning of the financial markets. Today, I will focus on provisions of particular concern to AllianceBernstein and the SIFMA AMG group. We believe significant changes must be made to the implementing regulations, particularly with respect to the market making exemption.[3]

Market making is a core function of banking entities and provides liquidity

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investment companies, state and local government pension funds, universities, 401(k) or similar types of retirement funds, and private funds such as hedge funds and private equity funds. In their role as asset managers.

[3] *See* Comment letter from Peter Kraus, AllianceBernstein L.P., dated November 16, 2011, on prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds http://1.usa.gov/xerq4f.

needed by all market participants, including pension funds and individual investors. The simplest market making activity involves exchange traded equity securities, where in most cases market makers are generally able to resell securities quickly. Other markets, however, are more complex and less liquid. In the fixed income market, for example, a single issuer may have many debt instruments outstanding with different terms and as a result there is fragmentation and intermittent liquidity for any single debt issue. Because in fixed income markets buyers and sellers are much less likely to wish to trade at the same moment in time, market makers bridge the gap and provide the immediate liquidity necessary for these markets to function. In carrying out this function, market makers are required to evaluate all risks in purchasing the security and transact with investors at a price that reflects those risks.

The Dodd-Frank Act expressly seeks to protect these functions by providing an exemption for "*The purchase, sale, acquisition, or disposition of securities and other instruments…in connection with underwriting or market-making-related activities…*" It is crucial that the market making exemption mandated by the Dodd-Frank Act be implemented in a manner that does not disrupt the liquidity necessary for functioning securities markets or impose potentially prohibitive costs and burdens on market participants.

Unfortunately, there are several problems with the proposed regulations. One significant issue is that they were drafted from the perspective of regulated market making activities for equity securities traded on organized markets such as exchanges, where intermediaries generally act as agents. The proposal clearly fails to account for different types of market making environments, particularly those related to fixed income and other over-the-counter ("OTC") markets, where market makers regularly trade as principal due to the high degree of fragmentation and intermittent liquidity. We believe the failure to take into account different OTC market making activities reflects a major oversight in the proposal and could have devastating effects on fixed income markets that exhibit intermittent liquidity.

In addition, the potential impact on liquidity would have negative consequences for mutual fund investors. Products that feature less liquid investments, like many fixed income funds, could experience difficulties with subscription and redemption activity. If banking entities reduce their role to agents and there is no other counterparty available, then mutual funds might face challenges in redeeming shares at the stated NAV. The result could be either few NAV style products in the market or a limited universe of securities for them to invest in, which would harm capital availability. Such a change could have consequences to the average retail consumer. For those who are living on a fixed income such as seniors, if these assets are illiquid or have significant decrease in value, it could have a negative impact on our aging population's ability to take care of themselves. It is also important to note, the negative impact it will have on those individuals who are doing the right thing by saving for their future retirement.

Rather than establishing applicable standards to govern permitted market making activities, however, the proposal creates a presumption that any "covered financial position" held for a period of sixty days or less is a prohibited proprietary transaction, essentially prohibiting market makers from holding inventory. Although banking entities can ostensibly rebut this presumption, the standards for doing so are unworkable for a number of reasons, and we are deeply concerned about the impact on liquidity. The proposal allows for rebuttal of the 60-day presumption if the banking entity can demonstrate the position was not acquired for any of a list of purposes. We believe this combination of a negative presumption with a list of restrictive conditions will encourage market makers to dispose of every position as quickly as possible to avoid the possibility that the transaction will be considered a prohibited proprietary trade. Banking entities may not only be hesitant to make markets in less liquid securities where they are not reasonably confident they can dispose of them immediately, but may also charge higher fees commensurate with the risks associated with the need to quickly dispose of the position.

Moreover, the proposal requires analysis of market making activity on almost a transaction-by-transaction basis. The operational burdens and costs associated with this process will be magnified by the costs involved in providing the new reports and

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tracking the information that banking entities are required to provide. The compliance program will be extremely complex, onerous, and require a significant build-out of resources, manpower and systems. The process also will be vulnerable to hindsight interpretations that fail to capture or downplay important facts and color that justified the trade at time of execution.

Ultimately the result of these onerous regulations, if adopted, will be a decrease in market liquidity and an increase in transaction costs. The resulting uncertainty will also increase volatility as market participants continue to search for and demand liquidity at the lowest possible transaction price at the expense of price volatility.

It is imperative that the implementing regulations take into account the fact that market making often involves a need to take short-term positions that will result in profit and loss. This activity is the natural economic result of the market maker's willingness to commit capital to facilitate orderly trading. The proposal, however, provides that market making revenues must not arise from a change in the pricing of positions, and relies heavily on the use of hedging as a means of enabling market makers to avoid profit and loss by offsetting the risks associated with taking short-term positions. This proposal fails to recognize that there are not perfect hedges for all securities. It is impossible to predict what the behavior of even the most highly correlated hedge will be versus the underlying asset being hedged. In general, the realization of some profit and loss is unavoidable even when a market maker commits capital to facilitate orderly trading of liquid securities with properly structured hedges.

The impact of the regulations will have broad implications. The ability of corporate issuers to raise capital in the U.S. by selling their debt securities is dependent on the availability of secondary market liquidity, which is largely provided by banking entities through their market making activities. We are convinced that the proposal will significantly reduce the liquidity of the secondary market for debt securities and is likely to have a profound and unintended adverse effect on our capital markets. The U.S. economy will be forced to bear both short-term and long-term costs associated with the reduction in market liquidity that will result from an overly restrictive interpretation of the Volcker Rule.

SIFMA AMG members, like AllianceBernstein, continue to work on crafting thoughtful responses to the proposed regulations and stand ready to assist the Agencies in ensuring final regulations enhance the safety and soundness of the U.S. financial system while ensuring integral market functions that impact the broader economy are preserved. Thank you, Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the Committee, for allowing me to present SIFMA AMG's views on this critically important topic.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Douglas James Peebles	**2. Organization or organizations you are representing:** AllianceBernstein
3. Business Address and telephone number: [redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? ☐ Yes ☑ No	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?** ☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
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