Written Statement of

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Subcommittee on Capital Markets and Government Sponsored Enterprises
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Hearing on the Impact of Dodd-Frank on Customers, Credit, and Job Creators

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I. Introduction

This written statement is submitted on behalf of the Bond Dealers of America (BDA), and the BDA appreciates the opportunity to set forth our views for the record of this important hearing. The BDA, with over fifty members headquartered coast to coast, is the Washington, DC, based organization that represents securities dealers and banks predominantly focused on the U.S. fixed income markets. The BDA is the only organization representing the unique interests of national, middle-market securities dealers. In addition to federal advocacy, the BDA hosts a series of meetings and conferences specific to domestic fixed income, in addition to spearheading industry cooperation on surveys and market practice documents.

Additional information about the Bond Dealers of America can be found by reviewing our website at www.bdamerica.org.

II. The Volcker Rule Should Not Be One Size Fits-All

While the BDA has many concerns with the Dodd-Frank Wall Street Reform Act of 2010 (Dodd-Frank or DFA), one of our primary concerns is the DFA requirement of a so-called Volcker Rule. Lost in the chorus of commentary about the impact of the multi-billion dollar trading loss incurred by JP Morgan Chase & Co. is the devastation that the Volcker Rule could impose on financial institutions and communities all around our country if the Rule is not drafted carefully and appropriately tailored. Little of this commentary has focused on the fact that the vast majority of banks - middle market and regional banks headquartered nationwide - do not engage in "portfolio hedging" to the tune of billions of dollars, if they engage in the practice at all. Yet, thus far, there appears to be an absence of recognition by the drafters of the Rule that not all banks or markets should be treated the same.

There are many securities broker-dealers affiliated with banks that specialize in the fixed-income markets that are likely to be subject to the restrictions on proprietary trading under the Volcker Rule, even though they do not represent any systemic risk to the financial system and did not cause the financial crisis that led to the enactment of Dodd-Frank. These bank affiliated broker-dealers are actively making markets in fixed income securities by acting as principal and thus are increasing efficiencies and reducing costs for investors. They are not engaging in proprietary trading in the manner originally addressed by former Chairman Paul Volcker. These firms represent middle-market brokers and dealers who are headquartered in cities all over the country, doing business throughout the United States coast to coast. They help communities around the country finance their schools, roads and bridges. They help businesses raise the funds they need to grow. They provide individuals and institutions with fixed income investment opportunities in municipal, corporate and agency-backed securities. They also provide liquidity for the investors in those securities.

The markets in fixed-income securities are not like the equity markets or the market in Treasury obligations. Most bonds do not trade very frequently, and they do not trade on exchanges. In the municipal market alone, there are over 50,000 issuers, most of which do not issue often; and each of which is unique. In such a market, broker-dealers play an important role by being familiar with the issuers and their credit, by selling bonds from their inventories to investors, and by purchasing bonds from investors to hold in their inventory for later resale – at a profit governed by the markup and markdown rules of the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority, and the Municipal Securities Rulemaking Board.

It usually goes like this. An investor approaches his or her broker-dealer in search of a suitable investment. The broker searches what is available – including what is in the broker's own inventory – and proposes an investment. Or, on the other side, an investor seeks to liquidate an investment; and unless his or her broker can find an immediate buyer, the broker purchases the bonds. As one can tell from that description, this looks a lot like proprietary trading; but it in fact is crucial to the operation of these markets. A Volcker Rule that makes no distinction on the basis of size and market type, principal trading versus proprietary trading could disrupt these markets, resulting in less liquidity and higher transactional costs for investors.

The Volcker Rule is supposed to have several exceptions that Congress intended to preserve the businesses and market functions of broker-dealers. Those include statutory exceptions for market making and for state and local obligations. However, if not crafted properly, the Volcker Rule could be too narrow, complex, and ultimately unworkable for these exceptions to be meaningful.

For example, the exception for market makers could be particularly troubling when it comes to fixed-income securities. This is because the SEC has never put forward a definition of market making for fixed-income securities, and the definition for equity market making is unsuitable for the fixed-income markets. Further, under the proposed Volcker Rule, only bonds that were issued by units of general government – such as a state, a county or a city – would be exempt from the Volcker Rule. Bonds issued by agencies or authorities – such as turnpike authorities, water and sewer districts, school districts, levee districts, housing authorities – would not be exempt. These latter bonds could face a diminished market, as bank-affiliated broker dealers would not be able to purchase or sell them from their inventory.

At a minimum, the Volcker Rule should provide that all state and local government bonds, including those of agencies and instrumentalities, are exempt from the Rule. Otherwise, the result could be that municipal securities investors will have less liquidity, issuers will have higher costs (which are ultimately passed on to taxpayers in the form of higher taxes or fees), and the current network of middle market broker-dealers who have served those investors and issuers will face greater stress.

The consequences of a broad, severe Volcker Rule that makes no distinctions on the basis of firm size or market type could be immense. A poorly drafted, overly-broad Rule with a one size fits-all approach could increase the costs to issuers of fixed-income securities, reduce investor liquidity, bifurcate the market in state and local bonds, and increase the business challenges of middle market broker-dealers. A fair cost-benefit analysis of such a Volcker Rule would undoubtedly establish that the Rule, as applied to fixed-income broker-dealers, is simply not worth the cost.

III. Conclusion

The BDA has several recommendations to the drafters of the Volcker Rule in order to avoid the adverse ramifications to the fixed-income markets set forth in this statement. Our foremost recommendation is that the Volcker Rule should not apply at all to fixed-income broker-dealers, even if they are affiliated with a financial institution. Alternatively, if that recommendation is not to be adopted, our secondary recommendation is that the Volcker Rule should not apply to securities broker-dealers affiliated with a financial institution with balance sheet assets of less than $10 billion. For certain, all state and local government bonds, including those of agencies and instrumentalities, should be expressly exempt from the Rule. And, finally, the Rule should incorporate by reference a definition of market making for fixed-income securities to be defined by the SEC.

Again, the Bond Dealers of America appreciates the opportunity to submit this written statement to the Subcommittee on Capital Markets and Government Sponsored Enterprises. If you have any questions or need any further information, please contact me at 202-204-7901 or at mnicholas@bdamerica.org.