

December 11, 2012

Spencer Bachus, AL, Chairman
Barney Frank, MA, Ranking Member
U.S. House of Representatives
Committee on Financial Services
Washington, DC. 20515

Dear Sirs,

Thank you for your invitation to testify at the hearing, "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Part II" on Thursday, December 13, 2012.

I was a member of the Investors' Working Group, an independent taskforce sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, which was co-chaired by Arthur Levitt and William Donaldson. The committee was founded in 2008 and submitted its report in July 2009. Our report recommended imposing careful constraints on proprietary trading at depository institutions and their holding companies. "Proprietary trading creates potentially hazardous exposures and conflicts of interest, especially at institutions that operate with explicit or implicit government guarantees."¹ When the committee was disbanded, I was asked to respond to questions about proprietary trading and provide continuity to interested parties.

The Volcker Rule

The Volcker Rule was first proposed in the wake of the Financial Crisis of 2008, and called for a direct ban on proprietary trading. However, as the crisis began to subside, the proposal's inclusion in the Dodd-Frank Act was changed to allow banks to continue proprietary trading with defined limitations. Its intent, or course, was to limit the major banks from engaging in speculative trading that would endanger customer deposits or accounts; and in particular, limit the bank's scope of trading and any systemic risk that would create a "too big to fail" crisis.

The subsequent debate and inclusion of exemptions has led to much inquiry on how to define certain aspects of the Act. At the most basic level, the vital question is whether a trade is providing liquidity to the marketplace to help a client, or whether it is a proprietary trade. In today's environment of sophisticated derivative instruments and algorithms, this question is incredibly difficult to answer. Congress has expended great effort to limit systemic risk from proprietary trading, yet still keep as much liquidity as possible in the current market system.

The Volcker Rule permits a number of client-oriented trading by banking entities. But those so-called "permitted activities" are also subject by the statute to additional capital charges, leverage limits, or other restrictions as the regulators deem appropriate. My testimony today will focus on how to improve The Volcker Rule by enhancing and clarifying the role of restrictions on leverage.

¹ *U.S. Financial Regulatory Reform: The investors' Perspective* (A Report by the Investors' Working Group, Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, July 2009) page 3

Financial Crisis

The repeal of The Glass-Steagall Act in 1999 allowed for the combination of Investment Banks and Commercial Banks. Significant consolidation followed and in 2002, these broker-dealers were allowed by the Securities Exchange Commission to increase their leverage from 12-13x to 30x the value of their equity, a freedom that no other financial institution was afforded. The leverage limits were regulatory guidelines, not statutory requirements, as the existing net capital rules allowed almost unlimited leverage. This increase in large part led to a catastrophic financial failure felt the world-over in 2008.

While the Financial Crisis of 2008 had far-reaching and deleterious effects throughout virtually every level of the global economy, the epicenter of the crisis itself was largely confined to six “bulge” broker-dealers: The Bear Stearns Companies, Inc.; Citigroup, Inc.; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Lehman Brothers Holding Inc.; and Morgan Stanley. In the wake of this crisis, two of the above broker-dealers failed, three came perilously close to failure, and one had a strong enough commercial bank balance sheet to weather the storm. Today, they are all bank holding companies, some with significant depository banks within the group.

Also caught up in the wake of this crisis were literally hundreds of hedge funds, broker-dealers, and commercial banks, which although sorely wounded, survived the bubble with minimum or no government support. Because of the existing market discipline on these “small enough to fail” firms, there were no failures that threatened the financial system as a whole.

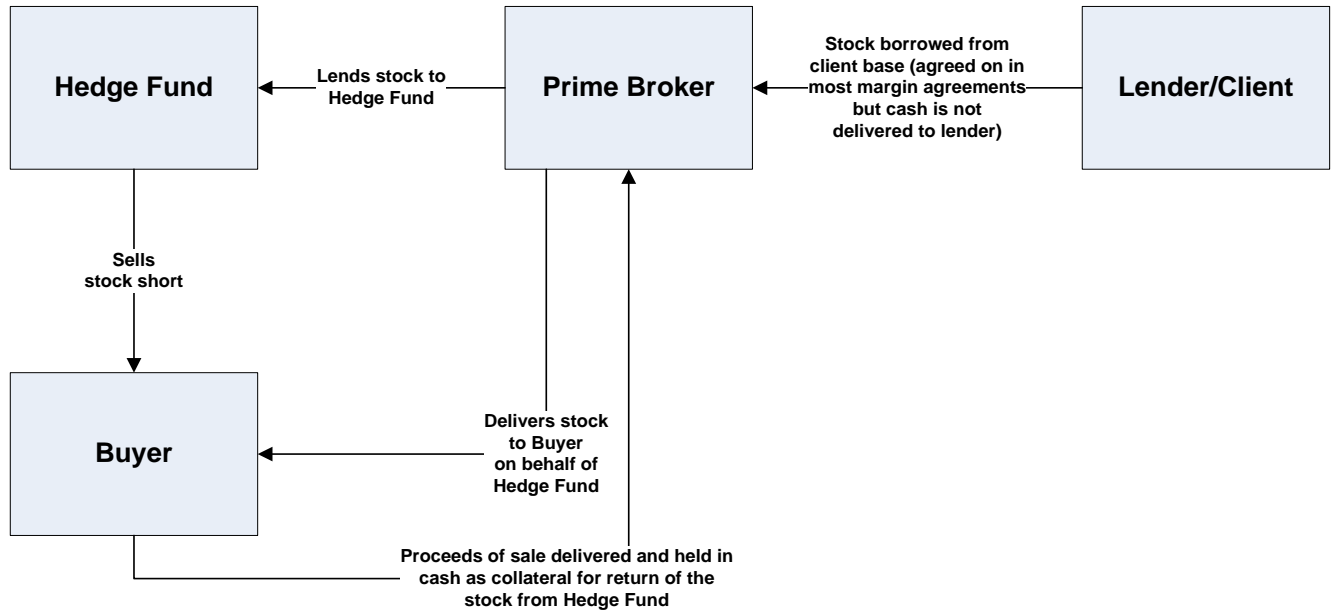
The Key to Almost Unlimited Leverage – The Broker-Dealer Exemption

Broker-dealers liquidity is measured by a daily Capital Adequacy Rule which is designed to limit capital commitments. They are allowed to net-out their longs and shorts to calculate their net capital requirements on the assumption that as market makers, they are providing liquidity to the market. As such, they are exempt from normal margin rules that control the leverage of other active trading hedge funds and individuals. This “dealer exemption” created a vehicle that allowed almost unlimited leverage and the dealer’s ability to borrow stock from his customer base gave him an extremely low cost of capital. In practice, however, even though they had to get “down” to 30x leverage by market close, many traded up to 3 or 4 times that during the course of the trading day, which provided a substantial loophole as capital adequacy is calculated at the end of the day. During the financial crisis of 2008, these enormous capital risks were rationalized by hedges of large short positions that were assumed to act rationally, but in reality seldom do in a crisis environment.

A great deal of trading today has moved to so called “dark pools” which are essentially providing a “matching” platform for buyers and sellers. While it is difficult to find reliable data, we estimate that specialist trading has ranged from 3-9% of total volume, and bulge firms now account for 25-30% of dark pool trading in competition with customer matching orders. Agency fees have fallen to 10-20 mils per share, indicating that equity trading is a very competitive market. Debt and other instruments have much less transparency, so it is difficult to estimate volumes, but the recent Blackstone announcement of a crossing system for debt suggests the same kind of matching platforms will add to liquidity and competitiveness in debt markets.

The Key to “Free” Money and Leverage – The Prime Brokerage Business

Most of the 6 broker-dealers that were seriously affected during the financial crisis were major players in the “prime brokerage” business. Since most hedge funds are short sellers to protect against major declines, these prime brokers were the overwhelming beneficiaries of the credit balances created by short sales.



The process described above created cash balances at the prime brokerage that effectively helped finance the broker-dealers’ massive trading accounts without paying interest and without any lender discipline. The remaining cash needed to finance these accounts came largely from the repo market and overnight loans. These loans are largely governed by balance sheet scale and are generally made only to the very large banks.

Both sources of cash are subject to little lender discipline and as such, at any signs of trouble, the market shuts down quickly. In this case, the repo market will “dry up” after the morning repayment, and the hedge funds will move their accounts to a “safer” home, forcing the prime broker to return the collateral cash when the short position is moved to another broker.

This constitutes a proverbial “run on the bank,” not by commercial bank depositors, but by hedge funds and repo lenders. This is why the CEO of Bear, Stearns In February 2008 could claim over \$20 billion of cash at the start of the week, and have virtually run out of cash by the end of the same week (see Exhibit 1, Lehman Brothers and Bear, Stearns Balance Sheets).

Non-Transparent Markets – Where the Market Fails

In a normal market environment, when leverage reaches a certain threshold, the owner of the trading position is forced to liquidate or reduce his position and pay off the lender. In the 2008 financial crisis, this did not occur as the mortgage securitization market was an over-the-counter market dominated by a small number of firms where tacit cooperation and self-interest among traders led to markets being maintained at unrealistic valuation despite the underlying assets of the mortgage securities steady decline.

Dealers when acting as specialists on an exchange platform must abide by specialist rules that generally include an obligation to maintain a market in difficult environments. In a dealer market off the exchange, there are no such obligations and a combination of order flow knowledge and profit incentives for traders, generally means that traders move in front of or with trading direction. Instead of providing liquidity against flow orders, in practice they add to the volatility.

In the case of OTC trading in securitized products and swaps, by the time that the risk was identified, there was no one in the marketplace willing to buy the positions, and therefore, the traders tried to hold pricing levels in the hope that other firms or funds would step in and purchase the positions. When no buyers materialized, these firms were forced to liquidate, resulting in huge and dramatic losses. For example, Merrill Lynch's CDO assets were valued at \$30.6 billion as of mid-June of 2008, yet were sold in July 2008 for \$7 billion. This downturn should not have been so dramatic and a more transparent market place should have reflected a more moderate market decline over a longer period of time.

A Solution that Worked in the Past

The Volcker Rule has often been compared to the Glass-Steagall Act of 1933, which was enacted as a result of the stock market crash in 1929. And, many observers of the Glass-Steagall Act point out that the underwriting abuses that it purportedly targeted were not the real problem. The Securities Exchange Act of 1934 passed control of margin requirements to the Federal Reserve System in order to give them control over leverage. Thus, the commercial banks were separated from the investment banks, and the investment banks were subject to market discipline on how much risk and leverage they could take. This worked reasonably well for almost 70 years, and during that time the United States enjoyed global leadership in equity and debt markets.

The governing principles for the majority of those seven decades were as follows:

- (1) Lending only on exchange traded instruments; and
- (2) Immediately selling out those positions that exceeded explicit margin requirements.

In the final analysis, allowing a small group of systemically significant broker-dealers, especially bank-back ones, unlimited leverage and with essentially tax payer-backed, low-cost financing, ultimately created a systemic risk that almost brought the whole financial system down.

When the market finally reflected the declining values in the mortgage market the short-term borrowing disappeared, and the hedge funds moved their short positions with the cash collateral, which created a proverbial "run on the bank."

The underlying concept of margin requirements is to limit possible losses to the amount of resources pledged against the loan, and would help insure that the broker-dealer balance sheet, which includes customer credit balances, would not be put at risk.

It is important to recognize that the leverage created in the system by the six aforementioned broker-dealers was legal, and the participants were not some rogue operators, but rather were the leading financial institutions in the marketplace. As trading technology commoditized traditional broker-dealer agency activity and eroded brokerage fees, the major firms moved aggressively towards proprietary activities to maintain their financial scale.

Summary

While broker-dealer balance sheets are remarkably opaque, it is now clear that the excessive leverage on the balance sheets of the too-big-to fail broker-dealers, now banks, were created by an absence of debt discipline and a dealer market that did not reflect true price discovery.

The bankruptcy of MF Global Holdings only reinforces the weakness of the capital adequacy rule, which allowed a broker-dealer to use its own balance sheet to support large trading positions. MF Global was leveraged by 34x its equity and used these funds to take a large position in European debt, yet was likely in compliance with the net capital rule. The “London Whale” incident at JPMorgan highlights how similar trading losses remain a problem in the core banking world as well.

The Volcker Rule, when it is finalized, should help restore some of the market discipline. It is important to remember that the law applies to both bank-affiliated firms and to systemically significant non-bank financial companies – thus ensuring that should any large stand-alone broker-dealers re-emerge, they will be covered too. However, to enhance The Volcker Rule’s efficacy, the final version should also include limitations in leverage and additional capital charges to those activities that it permits, such as market making, along the line of what I have discussed today.

Respectfully submitted,



William R. Hambrecht
Chairman
WR Hambrecht + Co

Attached: Exhibit 1, Balance Sheets for Lehman Brothers and Bear, Stearns

Lehman Brothers and Bear, Stearns Balance Sheets

Lehman Brothers

Balance Sheet							Press Release
Balance Sheet as of:	Q2	Q3	Q4	Q1	Q2	Q3	
	May-31-2007	Aug-31-2007	Nov-30-2007	Feb-29-2008	May-31-2008	Aug-31-2008	
Currency	USD	USD	USD	USD	USD	USD	
ASSETS							
Cash And Equivalents	5,293.0	7,048.0	7,286.0	7,564.0	6,513.0	-	
Cash & Securities Segregated	7,154.0	10,579.0	12,743.0	16,569.0	13,031.0	-	
Securities Owned	218,112.0	-	-	268,070.0	226,378.0	-	
Securities Purch. Under Agreem. To Resell	130,953.0	144,774.0	162,635.0	210,166.0	169,684.0	-	
Securities Borrowed	118,118.0	142,653.0	138,599.0	158,515.0	124,842.0	-	
Accounts Receivable	37,148.0	38,391.0	43,277.0	52,399.0	41,721.0	-	
Gross Property, Plant & Equipment	5,716.0	5,999.0	6,299.0	6,756.0	6,975.0	-	
Accumulated Depreciation	(2,197.0)	(2,322.0)	(2,438.0)	(2,567.0)	(2,697.0)	-	
Net Property, Plant & Equipment	3,519.0	3,677.0	3,861.0	4,189.0	4,278.0	-	
Goodwill	-	-	3,137.0	-	-	-	
Other Intangibles	3,652.0	4,108.0	990.0	4,112.0	4,101.0	-	
Invest. in Debt and Equity Securities	-	246,542.0	246,617.0	-	-	-	
Trading Asset Securities	-	35,711.0	44,595.0	-	-	-	
Other Current Assets	8,317.0	20,044.0	21,917.0	-	-	-	
Deferred Tax Assets, LT	-	-	2,309.0	-	-	-	
Other Long-Term Assets	73,595.0	5,689.0	3,097.0	64,451.0	48,884.0	-	
Total Assets	605,861.0	659,216.0	691,063.0	786,035.0	639,432.0	=	
LIABILITIES							
Accounts Payable	50,471.0	51,829.0	64,307.0	84,552.0	61,086.0	-	
Accrued Exp.	15,172.0	17,157.0	16,039.0	11,596.0	9,802.0	-	
Short-term Borrowings	203,097.0	268,394.0	269,296.0	292,528.0	222,233.0	-	
Curr. Port. of LT Debt	17,144.0	13,997.0	16,801.0	18,510.0	20,991.0	-	
Long-Term Debt	100,819.0	120,331.0	123,150.0	123,309.0	123,178.0	-	
Trust Pref. Securities	-	-	-	4,976.0	5,004.0	-	
Other Current Liabilities	168,015.0	140,840.0	149,617.0	196,903.0	141,507.0	-	
Other Non-Current Liabilities	30,014.0	24,935.0	29,363.0	28,829.0	29,355.0	-	
Total Liabilities	584,732.0	637,483.0	668,573.0	761,203.0	613,156.0	=	
Pref. Stock, Redeemable	1,095.0	1,095.0	1,095.0	2,993.0	6,993.0	-	
Total Pref. Equity	1,095.0	1,095.0	1,095.0	2,993.0	6,993.0	6,993.0	
Common Stock	61.0	61.0	61.0	61.0	61.0	-	
Additional Paid In Capital	9,610.0	9,802.0	9,733.0	11,129.0	11,268.0	-	
Retained Earnings	18,133.0	18,915.0	19,698.0	19,880.0	16,901.0	-	
Treasury Stock	(5,560.0)	(5,658.0)	(5,524.0)	(5,149.0)	(4,922.0)	-	
Comprehensive Inc. and Other	(2,210.0)	(2,482.0)	(2,573.0)	(4,082.0)	(4,025.0)	-	
Total Common Equity	20,034.0	20,638.0	21,395.0	21,839.0	19,283.0	19,283.0	
Total Equity	21,129.0	21,733.0	22,490.0	24,832.0	26,276.0	26,276.0	
Total Liabilities And Equity	605,861.0	659,216.0	691,063.0	786,035.0	639,432.0	=	

Bear, Stearns

Balance Sheet						
Balance Sheet as of:	Restated Q4 Nov-30-2006 USD	Q1 Feb-28-2007 USD	Q2 May-31-2007 USD	Q3 Aug-31-2007 USD	Q4 Nov-30-2007 USD	Q1 Feb-29-2008 USD
ASSETS						
Cash And Equivalents	4,595.0	5,891.3	11,178.3	18,142.6	21,406.0	20,786.0
Cash & Securities Segregated	8,804.0	9,125.9	4,652.6	13,459.8	12,890.0	14,910.0
Securities Owned	109,200.0	134,410.3	136,410.7	126,869.8	122,518.0	118,201.0
Securities Purch. Under Agreem. To Resell	38,838.0	37,248.0	42,271.7	32,144.2	27,878.0	26,888.0
Securities Borrowed	80,523.0	84,014.6	92,049.7	80,039.0	82,245.0	87,143.0
Accounts Receivable	35,601.0	39,837.3	45,828.4	42,264.5	52,737.0	52,844.0
Other Receivables	745.0	892.8	1,156.0	1,055.9	785.0	488.0
Gross Property, Plant & Equipment	1,632.0	1,700.3	1,607.0	1,689.8	1,754.0	1,804.0
Accumulated Depreciation	(1,152.0)	(1,192.1)	(1,059.9)	(1,104.1)	(1,149.0)	(1,196.0)
Net Property, Plant & Equipment	480.0	508.2	547.1	585.6	605.0	608.0
Invest. in Debt and Equity Securities	31,067.0	41,482.6	49,985.1	42,655.2	34,539.0	31,031.0
Deferred Tax Assets, LT	1,431.0	-	-	-	1,464.0	-
Other Long-Term Assets	39,149.0	41,100.8	39,224.0	39,874.5	38,295.0	46,096.0
Total Assets	350,433.0	394,511.9	423,303.7	397,091.0	395,362.0	398,995.0
LIABILITIES						
Accounts Payable	76,386.0	80,984.5	88,565.6	73,805.7	87,305.0	97,274.0
Accrued Exp.	4,018.0	2,076.0	2,956.8	3,060.8	2,952.0	1,213.0
Short-term Borrowings	122,128.0	143,080.3	152,955.6	148,084.4	143,804.0	135,972.0
Curr. Port. of LT Debt	-	-	-	1,362.0	9,586.0	7,166.0
Long-Term Debt	83,650.0	97,880.9	109,451.0	102,169.1	89,294.0	91,063.0
Trust Pref. Securities	-	262.5	262.5	262.5	263.0	263.0
Other Current Liabilities	30,392.0	32,144.3	33,533.7	33,398.8	30,315.0	35,034.0
Other Non-Current Liabilities	21,730.0	24,809.5	22,270.4	21,947.3	20,050.0	19,114.0
Total Liabilities	338,304.0	381,238.0	409,995.6	384,090.5	383,569.0	387,099.0
Pref. Stock, Redeemable	359.0	359.2	359.2	351.6	352.0	352.0
Pref. Stock, Other	-	-	-	-	-	-
Total Pref. Equity	359.0	359.2	359.2	351.6	352.0	352.0
Common Stock	185.0	184.8	184.8	184.8	185.0	185.0
Additional Paid In Capital	4,579.0	4,902.7	4,936.9	4,966.3	4,986.0	5,619.0
Retained Earnings	9,385.0	9,894.9	10,211.3	10,338.2	9,441.0	9,419.0
Treasury Stock	(4,445.0)	(4,610.6)	(4,888.2)	(5,339.4)	(5,641.0)	(2,913.0)
Comprehensive Inc. and Other	2,066.0	2,543.0	2,504.1	2,499.0	2,470.0	(766.0)
Total Common Equity	11,770.0	12,914.8	12,948.9	12,648.8	11,441.0	11,544.0
Minority Interest	-	-	-	-	-	-
Total Equity	12,129.0	13,273.9	13,308.1	13,000.5	11,793.0	11,896.0
Total Liabilities And Equity	350,433.0	394,511.9	423,303.7	397,091.0	395,362.0	398,995.0